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THE EURO AND THE INTEGRATION OF FINANCIAL SERVICES

THE €UROSYSTEM

WHAT IS THE EURO?

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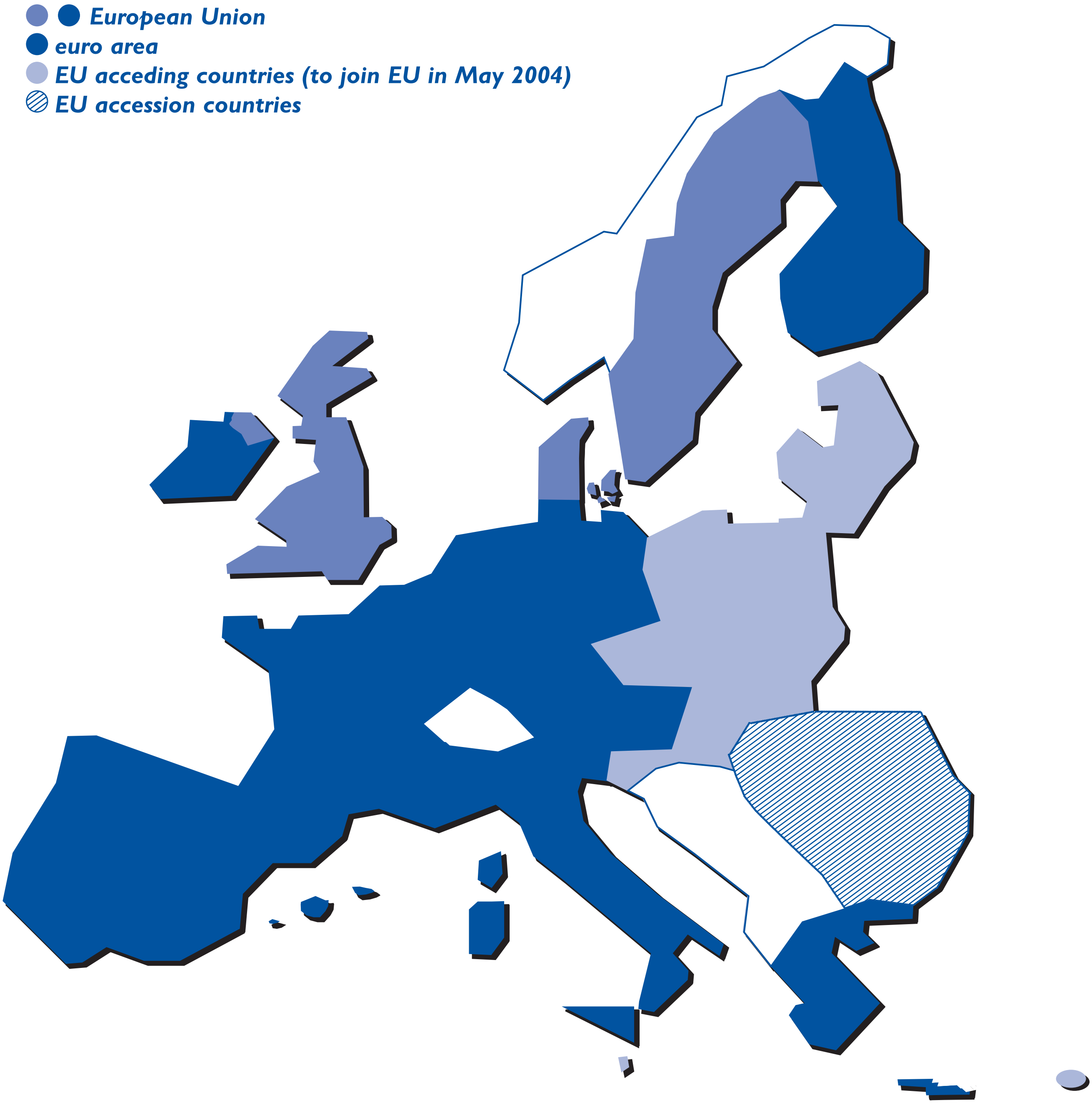
THE €UROSYSTEM

I The euro area – a single currency area

The launch of the euro on 1 January 1999 gave birth to a new economic zone – the euro area. Composed of 12 Member States of the European Union (EU), Belgium, Germany, Greece (from 1 January 2001), Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland, it is the second largest economy in the world and the largest trading block.

The introduction of a single currency for more than 300 million European citizens provides substantial benefits for both consumers and businesses. In particular, it facilitates trade in goods and services between the participating countries, thus strengthening the Single Market within the EU.

Key figures for 2002			
	Euro area	United States	Japan
Population (in millions)	307.8	287.5	127.3
GDP (as a % of world GDP)	16.0	22.0	7.3
Exports of goods and services (as a % of world exports)	17.1	14.5	8.9


European Union
euro area
EU acceding countries (to join EU in May 2004)
EU accession countries



integration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soundness

The Eurosystem

The Eurosystem is composed of the European Central Bank (ECB), which has its seat in Frankfurt am Main (Germany), and the national central banks (NCBs) of the 12 countries forming the euro area.

Basic tasks

The basic tasks of the Eurosystem are:

- to define and implement the monetary policy of the euro area;
- to conduct foreign exchange operations;
- to hold and manage the official reserves of the euro area Member States; and
- to promote the smooth operation of payment systems.

A complementary task is to contribute to the smooth conduct of national policies in the fields of prudential supervision and financial stability.

The primary objective of the Eurosystem is to maintain price stability in the euro area, thus protecting the purchasing power of the euro. The Governing Council of the ECB has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. The Governing Council has recently clarified that, in its pursuit of price stability, it aims to maintain inflation rates close to 2% over the medium term.

Without prejudice to this primary objective, the Eurosystem also supports the general economic policies of the EU.

Governance

There are two main decision-making bodies of the ECB.

- The Executive Board, consisting of the President, the Vice-President and four other members. All members are appointed by the European Council (Heads of State or Government). Its main tasks are to prepare and implement decisions made by the Governing Council and to manage the ECB.
- The Governing Council, which is composed of the six members of the Executive Board and the governors of the NCBs of the euro area. Its main responsibility is to formulate the single monetary policy for the whole of the euro area.

The Eurosystem is independent. Neither the ECB, nor any euro area NCB, nor any member of their decision-making bodies may seek or take instructions from third parties.

The Eurotower in Frankfurt am Main is the seat of the European Central Bank.

TOWARDS A SINGLE MARKET FOR FINANCIAL SERVICES IN THE EURO AREA

II

With the launch of the euro and the start of the single monetary policy, the financial markets of all participating countries have been merged to form a single euro area financial market. The breadth and depth of this market allows the exploitation of greater economies of scale and thus provides issuers and investors with more and better financial services at lower costs. This is in line with the objective of the EU to form a single market for, among other things, financial services.

However, while the existence of multiple currencies was the greatest single obstacle to financial integration in the euro area, it was not the only obstacle. In order to reap all the benefits of the single currency, European financial integration must be completed by the removal of these other barriers. This is being achieved through the interplay between the actions of the public authorities of the EU and those of market participants. The ECB is supporting this ongoing process through its expertise in financial markets and their infrastructure, by acting as a catalyst for collective actions aimed at furthering financial integration and by taking relevant action within its areas of competence.





Although the pace of integration varies, evidence of it can be found in all parts of the financial system:

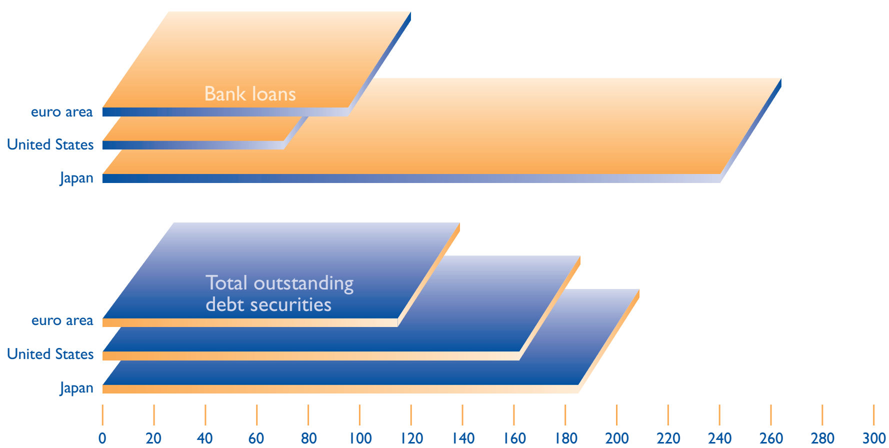
- the euro area money market is highly efficient and integrated;
- the euro-denominated bond market is well-integrated, deep and liquid, and provides a wide choice of investments and funding;
- the euro area equity market is increasingly viewed as a single market; and
- consolidation has gained pace at both national and euro area level in the banking sector and among market infrastructure operators.

Euro area financial structure

The depth and high quality of the single financial market facilitate the financing of the economy and the investment and savings-related decisions of private agents. There is a comprehensive range of financial products and trading facilities available in euro. Furthermore, the continuous introduction of new financial instruments widens the choice of corporate financing possibilities, providing hedging opportunities against various financial risks and facilitating the management of investment portfolios.

By comparison with the United States and Japan, the banking sector plays a relatively important role in Europe. However, the introduction of the euro has accelerated the pace of development of securities markets as an alternative method of financing that emerged in the 1990s, thereby resulting in a balanced financial structure offering many different avenues of finance. Financial markets have expanded rapidly since the introduction of the euro and are expected to expand further in the years to come.

Financial structure *(% of GDP), end-2002*



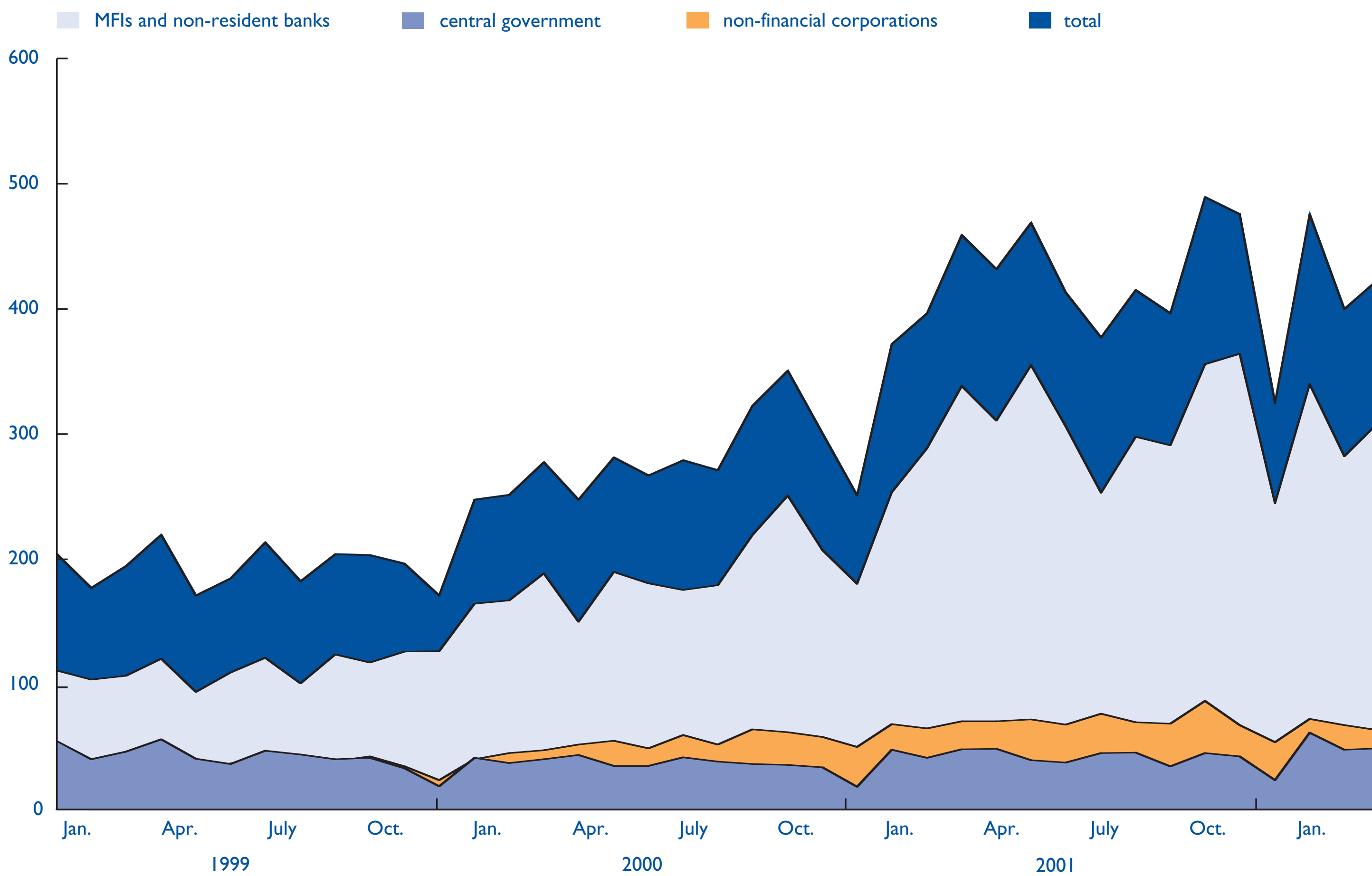
Integrating the euro area money markets

In response to the single monetary policy framework created by the introduction of the euro, the money market has undergone a very swift and wide-ranging process of integration and standardisation. The existence of a single short-term interest rate, set by the ECB, and a euro area-wide gross payment system (the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET), see chapter IV) led to a high level of integration of the interbank deposit market very soon after the introduction of the euro.

For other segments of the euro area money market, such as the repurchase agreement (repo) market and the short-term securities markets (for Treasury bills, commercial paper (CP) and certificates of deposit (CDs)), the process of integration has been slower but is still continuing, with several ongoing initiatives originating from both the public and the private sectors.

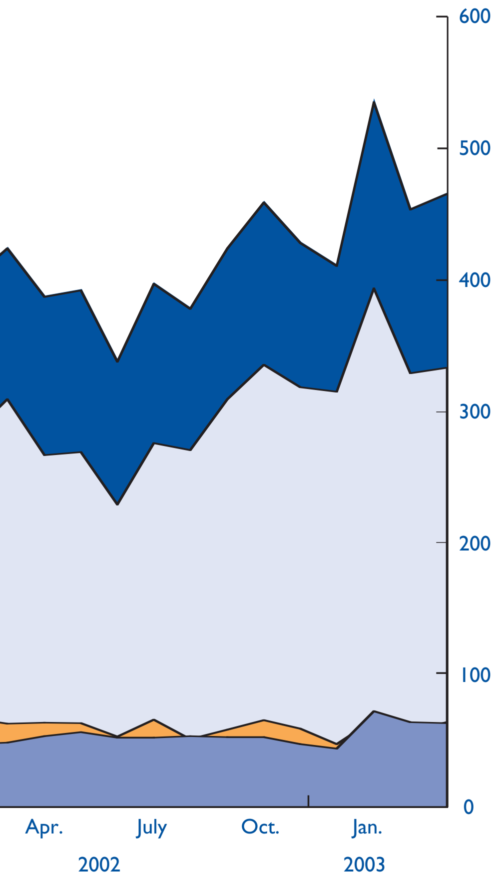
The need to redistribute liquidity among the euro area countries,

Gross issuance of euro-denominated short-term securities by issuer sector



including the liquidity provided by the Eurosystem as part of its refinancing operations, has fostered the development of euro area-wide transactions. Transactions with non-national counterparties amount to more than 50% of the overall activity in all segments of the money market.

TARGET, which is the main settlement system for payments in euro, has played a key role in facilitating the redistribution of liquidity across the euro area. Moreover, TARGET has facilitated arbitrage activity and has therefore led to an equalisation of the prices prevailing in the various segments of the money market throughout the euro area.



Integrating euro area bond markets

The euro has created a more homogeneous bond market marked by a wide enlargement of the investor base especially outside the euro area and a significant reduction in underwriting costs. The most significant change in this sector was the jump in the issuance of corporate bonds in 1999, which has since been maintained, although at lower levels. An increase in liquidity is reflected in large private issues of above €1 billion.

The government bond market also benefited from the euro, which has increased the homogeneity of different sovereign issues and therefore their substitutability. As a result of competition between sovereign issuers in the Treasury bond market, issuance programmes have often been redesigned with a view to, among other things, increasing the liquidity of each instrument. In addition, new instruments have been issued by several governments, such as inflation-linked bonds linked to the euro area HICP (excluding tobacco).

Integrating the euro area equity markets

The development and growing use of euro area-wide stock market indices, the shift in the asset allocation paradigm to sector instead of country, diversification, and the merger of equities and derivatives markets are some of the key moves towards a single market.

SECURITIES MARKET ORGANISATION

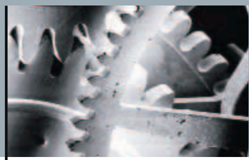
III

The euro area securities infrastructure is being transformed mainly by means of mergers. The ultimate goal of the consolidation process is to provide market participants with a single gateway to all euro area securities. In this context, the Eurosystem is promoting a level playing-field, as well as free competition in the development of the securities infrastructure.

Developments in euro area securities trading

In the area of securities trading, the euro area now has a cross-border market for debt instruments and repos that uses pan-European electronic communications networks, which in many cases are replacing domestic over-the-counter trading. In addition, the securities trading infrastructure in the euro area has recently witnessed a number of mergers and alliances. One of these was the merger of the Amsterdam, Brussels, Lisbon and Paris stock exchanges to form Euronext. This, and similar projects that may follow, will continue to increase the liquidity of euro area securities markets.

The Eurosystem encourages and promotes market initiatives which foster the development of a single euro area market.


Integrating clearing functions in the euro area

Clearing activity is concentrated in a limited number of clearing houses, which act as the central counterparties for securities and derivatives operations. Economies of scale in clearing operations call for further integration, such as the recently announced merger between Clearnet[1] and the London Clearing House (LCH).

The Eurosystem is closely monitoring developments in the sector and welcomes initiatives to enhance the efficiency of the euro area market in terms of costs and security.

Settlement in the euro area – swift and secure processes

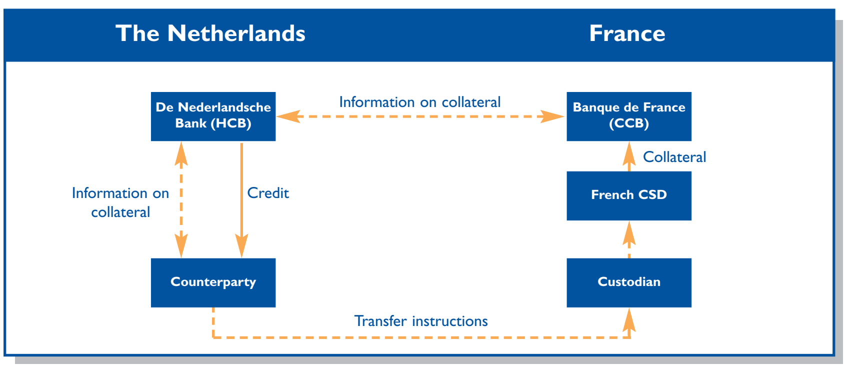
The process of rationalisation and integration in the securities settlement industry is building on national infrastructures and is taking place either through linkage arrangements between securities settlement systems (SSSs), mainly following the model defined by the European Central Securities Depositories Association (ECSDA), or through mergers. Thanks to this process, market participants are increasingly able to perform cross-system transfers. The consolidation process has already yielded significant results. For instance, the German and Luxembourg systems have merged to form Clearstream, with the aim of creating a single platform, and the Belgian, Dutch, French, Irish and British systems have merged with Euroclear Bank in order to offer a single integrated settlement process. Furthermore, the rationalisation of the local market infrastructure has allowed the emergence of single systems in Italy (Monte Titoli) and Spain (Iberclear).

However, from the very start, the Eurosystem has ensured that all collateral eligible for use either in monetary policy operations or for obtaining liquidity in TARGET has been available to all market participants, regardless of the location of the collateral or the participants.

It was for this reason that the correspondent central banking model (CCBM) was set up. The CCBM, which was developed as an interim solution, has been operating successfully since 4 January 1999. It is a mechanism whereby central banks act as securities custodians for one another. The CCBM can be used only to collateralise central bank credit, leaving the market to develop services to allow for the cross-border use of collateral in other types of operations.

In addition, there are 66 links between SSSs, which have been deemed eligible by the Governing Council for the transfer of securities in the Eurosystem's monetary policy and intraday credit operations.

Flow of information within the CCBM



HCB = home central bank, CCB = correspondent central bank, CSD = central securities depository

(For further details, see the CCBM brochure on the ECB's website at www.ecb.int)

[1] *Clearnet is the clearing house of the Euronext exchanges (Amsterdam, Brussels, Lisbon and Paris).*

ENHANCED PAYMENT SERVICES IN THE EURO AREA

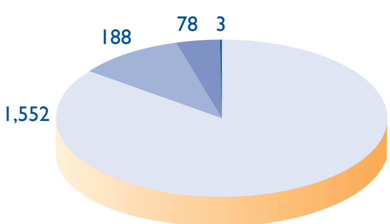
IV The payment infrastructure for large-value payments in the euro area is characterised by the coexistence of five large-value payment systems.

The Eurosystem provides the TARGET system, the real-time gross settlement (RTGS) system for the euro. TARGET allows euro payments to be settled in central bank money with immediate finality and has a daily turnover of some €1.7 trillion. TARGET has a decentralised structure comprising 15 national RTGS systems and the ECB payment mechanism (EPM), which are interconnected.

In addition to TARGET, large-value payments in euro are processed by the EURO 1 system (operated by the Euro Banking Association – EBA), PNS (Paris Net Settlement) in France, SPI (Servicio Español de Pagos Interbancarios) in Spain and POPS (Pankkien On-line Pikasiirrot ja Sekit-järjestelmä) in Finland.

Large-value payment systems in euro

(daily average value in EUR billions – year 2002)



In the field of large-value payments in euro, TARGET has a market share of about 85% in terms of value and 59% in terms of volume. The EURO 1 system has become the most extensively used alternative to TARGET. Correspondent banking within the euro area has declined substantially since the introduction of the euro.

TARGET – the backbone of the euro payment systems infrastructure

The TARGET system was developed to meet three main objectives:

- to provide a safe and reliable mechanism for the settlement of euro payments on an RTGS basis;
- to increase the efficiency of cross-border payments within the euro area; and, most importantly,
- to serve the needs of the monetary policy of the ECB.

Payments directly related to monetary policy operations involving the Eurosystem, whether as the recipient or the sender, have to pass through TARGET. Cross-border large-value net settlement systems operating in euro also settle their end-of-day balances via TARGET. Thus TARGET is used for the end-of-day settlement of EURO 1. TARGET is also used for euro payments between CLS Bank and its members.

TARGET is widely accessible and is used for all credit transfers in euro between EU countries, as well as within the same country. It processes both interbank (MT-202) and customer (MT-100/103/103+) payments without there being a limit on their value. All payments are treated equally, irrespective of their value.

Liquidity is widely available in TARGET. It allows market participants to centralise their treasury operations, as liquidity can be transferred easily and swiftly throughout the euro area. Minimum reserve holdings are available for settlement purposes during the day and the Eurosystem provides unlimited (collateralised) intraday credit free of interest to its counterparties.

Small and medium-sized banks, which do not have access to other systems, value TARGET because of its low costs and high operational efficiency.

The future – TARGET2

The next generation of the system (TARGET2) is now under consideration. While NCBs will remain responsible for the accounts and business relations with the participants from their own jurisdictions, TARGET2 will introduce a common shared platform with a high level of harmonisation of central bank practices. The new system will propose a uniform price structure based on the costs of the most efficient platform.

In association with market participants, the Eurosystem is defining the user requirements of the system, which is due to become operational during the second half of this decade.

EU enlargement

Upon joining the EU, the acceding country central banks will have the opportunity, but not the obligation, to connect to TARGET. Participation in TARGET will be compulsory only when the respective Member States participate in Economic and Monetary Union (EMU), i.e. when they adopt the euro in place of their national currencies.

Further information on TARGET can be found on the ECB's website at http://www.ecb.int or can be obtained from target.hotline@ecb.int.

Retail payments

Through the European Payments Council the European banking industry has initiated the creation of an efficient single euro payments area (SEPA) by 2010. The aim is to increase the efficiency of the retail payments infrastructure, in particular through the development of a new pan-European automated clearing house (ACH) infrastructure. Such an infrastructure is already emerging. The EBA's STEP 2 retail clearing system started its operations in April 2003.

In relation to e-payments, while the initiatives are still at an early stage of development, the Eurosystem is encouraging the emergence of secure innovative payment instruments and systems. In particular, the main aim of the Eurosystem is to foster co-operation in the euro area and consensus-building in the European e-payments market. The e-Payments Systems Observatory (e-PSO) website (www.e-pso.info) facilitates the exchange of information in the market and the observation of developments in this field.

A SAFE AND EFFICIENT MARKET FOR FINANCIAL SERVICES

V In the euro area, the soundness of all components of the financial markets is adequately ensured.

Banking supervision

The Governing Council is the single monetary authority for the euro area, but the prudential supervision of banking and financial institutions remains a national responsibility. However, the Eurosystem and the ECB perform two major functions related to prudential supervision and financial stability.

- The Eurosystem contributes to the smooth conduct of policies by the competent authorities in the fields of prudential supervision and financial stability. This task is carried out mainly with the assistance of the Banking Supervision Committee (BSC), which was established in June 1998 and is composed of high-ranking officials from supervisory authorities, NCBs of EU countries and the ECB. The BSC's activities focus on the monitoring of financial stability and structural developments in the banking and financial sector. The BSC may also act as a forum for consultation among EU banking supervisors on issues not related to the tasks of the Eurosystem.
- The ECB is consulted on draft national and Community legislation in the areas of prudential supervision and financial stability, and it gives advice on the scope and implementation of Community legislation in these areas.

Arrangements are also in place between the Eurosystem and banking supervisors in the EU concerning the management of banking crises.

Article 22 of the Statute of the ESCB

Clearing and payment systems

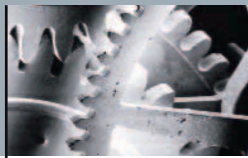
"The ECB and national central banks provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries."

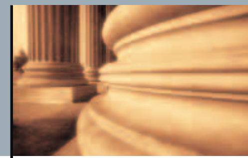
Oversight of payment systems

As well as operating TARGET and acting as a catalyst for change in the field of cross-border retail payments, the Eurosystem fulfils its basic statutory task of "promoting the smooth operation of payment systems" through its oversight function.

The oversight of the Eurosystem covers all payment systems operating in euro and aims to ensure their safety and enhance their efficiency. It is based on a common policy stance, formulated by the Governing Council, which is enforced either by the ECB or by the NCBs.

The common oversight policy is based on a set of standards developed either at the international level, such as the "Lamfalussy standards" and the "Core principles for systemically important payment systems" as prepared by the Committee on

Payment and Settlement Systems (CPSS) of the G10 central banks, or within the Eurosystem, such as the requirements set out in the ECB's 1998 report on electronic money.

All large-value systems operating in euro were assessed against the Lamfalussy standards by the Eurosystem prior to the start of Stage Three of EMU. In December 1998, the Governing Council agreed that all such systems could operate in euro as from 4 January 1999. The Eurosystem is currently finalising its assessment of all systemically important payment systems in the euro area against the "core principles" and will make the results of its assessment public in the near future.

Safe and sound securities clearing and settlement systems

In order to secure its credit operations and to ensure a level playing-field among its counterparties, the Eurosystem has defined standards (published in January 1998) for EU SSSs, and for the links between them, in relation to Eurosystem credit operations. The guiding principles of the Eurosystem are to ensure equal treatment of institutions located in the euro area when accessing central bank credit and to promote the soundness and efficiency of SSSs in the euro area.

These standards address four main categories of risk covering legal, settlement, custody and operational aspects related to the use of SSSs within the context of the Eurosystem credit operations. Each SSS has been assessed against these standards and is reviewed annually.

The standards have significantly improved the soundness and efficiency of euro area SSSs. They have triggered adjustments in the organisation of SSSs which are of benefit to all those who use their settlement services.

Furthermore, in the last decade the central bank community has become increasingly active in the field of securities clearing and settlement systems with a view to the general objective of financial stability, a crucial condition for the smooth implementation of monetary policy. In this context, the Eurosystem has actively participated in the work carried out at a global level by a joint task force bringing together G10 central banks and securities regulators (through the CPSS and the International Organisation of Securities Commissions (IOSCO)), which has defined recommendations for securities clearing and settlement systems.

At present, the European System of Central Banks (ESCB), which comprises all EU central banks, is co-operating with the Committee of European Securities Regulators (CESR) to define a regulatory framework for the securities clearing and settlement market infrastructure. In particular, the ESCB and CESR are jointly developing standards that will enhance the safety, soundness and efficiency of the European securities market infrastructure. Another reason for laying down standards is to foster integration within the EU by promoting harmonised rules for clearing and settlement activities. The standards address issues related to, among other things, pre-settlement, settlement, clearing, custody and operational reliability.

EUROPEAN CENTRAL BANK