

ARTICLES

THE CONTRIBUTION OF THE ECB AND THE EUROSISTEM TO EUROPEAN FINANCIAL INTEGRATION



This article provides an update on the ECB's ongoing work on monitoring and assessing the state of European financial integration and presents, on the basis of selected examples, the activities through which the ECB and the Eurosystem contribute to fostering that process. It follows up on an earlier article on this topic which was published in the October 2003 issue of the Monthly Bulletin. The ECB has a keen interest in progress towards European financial integration, since it is of great importance to the Eurosystem's tasks under the Treaty establishing the European Community, namely to maintain price stability via the implementation of the single monetary policy in the euro area, to contribute to safeguarding financial stability and to promote the smooth operation of payment systems. More generally, the relevance of European financial integration in a broader economic context has also been highlighted by the recently renewed Lisbon agenda, which aims to strengthen economic growth and increase employment in Europe, and which the Eurosystem fully supports.

I INTRODUCTION

For various reasons, both broad economic and Eurosystem-specific, the ECB and the Eurosystem have a keen interest in progress towards European financial integration. The ECB therefore monitors this process closely. In September 2005 the ECB published a first set of indicators of financial integration and an accompanying report assessing the current state of euro area financial integration. Partly on the basis of that report and partly extending that analysis, this article describes, as a first aim, selected aspects of the current state of financial integration in the euro area.

It is essential to conduct an ongoing analysis of the state of European financial integration and to monitor its progress over time in order to reveal the areas in which integration is progressing and those in which it is lagging behind and where action may possibly be required. As a second aim, this article therefore provides an overview of relevant activities undertaken by the ECB and the Eurosystem to foster European financial integration. In this respect, it is noted that two types of actor are striving to foster financial integration: market participants and public authorities. The Eurosystem is of the view that financial integration is first and foremost a market-driven process. This view is also shaped by the general

provision laid down in Article 105(1) of the Treaty that the Eurosystem should act "in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources". In accordance with this provision, the Eurosystem believes it to be a basic task of the relevant public authorities to create a framework conducive to fostering financial integration. If the opportunities this creates are exploited by market forces, true financial integration will be achieved. An analysis of the state of financial integration and the monitoring of its progress over time are therefore prerequisites for possible action by public authorities, such as the Eurosystem, to promote financial integration in those areas in which gaps and shortcomings have been identified.

The article is organised as follows. Section 2 explains the various reasons why the ECB and the Eurosystem have a keen interest in progress towards financial integration in Europe. Starting with the ECB's working definition of financial integration, Section 3 outlines the ECB's basic conceptual framework and provides a summary of the current state of financial integration in the euro area. Section 4 gives an overview, based on selected examples, of the various kinds of activity undertaken by the ECB and the Eurosystem to foster European financial integration. Section 5 concludes.

2 THE EUROSISTEM'S INTEREST IN EUROPEAN FINANCIAL INTEGRATION

There are several reasons why the ECB and the Eurosystem have a keen interest in European financial integration. First, financial integration is of key importance for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Second, financial integration is highly relevant to the Eurosystem's task of contributing to safeguarding financial stability. Third, financial integration is fundamental both to the Eurosystem's task of promoting the smooth operation of payment systems and to its strong interest in the safe and efficient functioning of securities clearing and settlement systems. Finally, it is generally accepted that financial integration contributes to increasing the potential for stronger non-inflationary economic growth. The Eurosystem therefore attaches great importance to furthering progress in European financial integration.¹

GENERAL ECONOMIC BENEFITS

Financial integration is a key component of the general economic policy of the European Union. In 1999, with a view to implementing the Lisbon strategy in the field of financial integration, the European Commission initiated the Financial Services Action Plan (FSAP), which was completed in 2005. In 2005, following a mid-term review, the European Council relaunched the Lisbon strategy, which has two main goals: to strengthen growth and to increase employment in Europe. The Eurosystem fully supports this programme. Structural reforms, such as improving the flexibility of labour markets, increasing competition in the markets for goods and services and fostering knowledge and innovation, are urgently needed in Europe. Moreover, the need for structural reforms is not confined to the "real" side of the economy, but also applies to its financial side, and hence also to financial integration. In December 2005 the European Commission released its "White Paper on Financial Services Policy 2005-2010",

which shapes the current policy programme in the field of financial services.

The general economic benefits arising from financial integration can be summarised as follows. Financial systems serve to channel funds from those economic agents that have a surplus of savings to those which have a shortage, and to trade, hedge, diversify and pool risk. These functions are facilitated by financial integration, as it leads to better sharing and diversification of risk and an increased potential for stronger non-inflationary economic growth. Economic agents can invest more easily in other regions of the euro area and thereby diversify the risk of potential local shocks impacting on income and consumption. Furthermore, by making markets deeper and more liquid, financial integration creates economies of scale and increases the supply of funds for investment opportunities. The integration process fosters competition, the expansion of markets and intermediation, thereby leading to further financial development. Financial development in turn leads to lower intermediation costs and a more efficient allocation of capital. Allocating resources to the most productive investment opportunities ultimately increases the potential for stronger and more sustainable non-inflationary economic growth. A financial system, such as the euro area, that is not yet fully integrated in all of its components therefore implies a cost in terms of foregone economic growth.

The basis for the interest of the ECB and the Eurosystem in European financial integration and its general economic benefits is Article 105(1) of the Treaty, which states that the ESCB should, "[w]ithout prejudice to the objective of price stability, [...] support the general economic policies in the Community [...] as laid down in

¹ The Eurosystem's determination in this respect is also reflected in its mission statement: "[...] We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration." See the ECB's website at http://www.ecb.int/ecb/orga/escb/html/mission_eurosys.en.html.

Article 2”, namely to achieve sustainable and non-inflationary growth.

FINANCIAL INTEGRATION AND MONETARY POLICY

A well-integrated financial system is essential for the implementation of monetary policy, as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Monetary policy transmission is the process through which monetary policy decisions affect the price level and the output of the economy. Since monetary policy decisions are implemented and transmitted through the financial system, the degree of financial integration affects the effectiveness of this transmission. While the single monetary policy is capable of ensuring price stability – and has done so successfully over the past seven years – even if financial integration is less than complete in certain areas, the transmission of monetary policy could, in such a situation, still potentially affect euro area countries in a heterogeneous manner.

This is evident from the two main monetary policy transmission channels: the interest rate channel and the credit channel. In the context of the interest rate channel of monetary policy, central banks influence the intertemporal allocation of resources via the sensitivity of aggregate demand with regard to changes in interest rates. While some of its determinants (such as the intertemporal elasticity of substitution of the household sector) are not observable, it is very likely that this sensitivity is influenced by the efficiency with which the financial sector transmits changes in the monetary policy stance to the broad range of interest rates and yields. Developments in the interest rates on bank loans and deposits are highly important for the saving and financing decisions of households and non-financial corporations. Differences in bank interest rates are due not only to asymmetric conditions in national economies – such as credit and interest rate risk, firm size, industrial structure and capital market development – but also to institutional factors – such as differences in taxation, regulation and the effectiveness of

supervision – and to financial structures – such as the degree of bank financing in relation to capital market financing and the openness and competitiveness of market participants across euro area countries. Differences in the reaction of bank interest rates may lead to an inefficient transmission of the single monetary policy. In this respect, enhanced integration in the banking markets may reduce the heterogeneity of bank interest rates’ response to changes in money market rates across euro area countries (see also Section 3).

The credit channel emphasises the role played by bank credit supply. It relates to the extent to which central bank actions affect bank behaviour in terms of loan supply, and the degree to which the financing of the economy is bank-based. This channel has an impact on firms that are highly dependent on bank financing and which would be forced to abandon their investment projects if they were unable to obtain it. Greater cross-border financial integration as a result of a broadening of the pool of available assets for investment may potentially enhance the heterogeneity of banks’ portfolios, enabling them, for instance, to more easily offset a monetary policy tightening. The development of an integrated corporate bond market is also of relevance, as a shift from bank financing to market financing may imply a diminished role for the credit channel of monetary policy.

Since the outset of Monetary Union, observers have occasionally raised concerns about possible asymmetries and inefficiencies in the monetary policy transmission mechanism and a potentially asymmetric impact of monetary policy impulses across euro area countries.² Overall, while there is some evidence that the individual channels of the monetary transmission mechanism do not operate in a fully symmetrical manner across the euro area economies, such

² See Angeloni, I., A. K. Kashyap and B. Mojon (eds. 2003), “Monetary Policy Transmission in the Euro Area. A Study by the Eurosystem Monetary Transmission Network”, Cambridge University Press, and the report of the Inflation Persistence Network, June 2005, at <http://www.ecb.int/home/pdf/research/inflationpersistencepricesettingreport.pdf>.

asymmetries seem to broadly compensate each other as regards the overall response of output and inflation to a monetary impulse. However, differences do seem to exist, which may reflect, in addition to the different structures of financial institutions and markets, a lack of financial integration.³ Consequently, and since the ECB's monetary policy aims at preserving price stability in the whole euro area, for which it has one instrument at hand, namely the steering of short-term interest rates, differences and inefficiencies in the euro area financial system also need to be addressed by structural policies that enhance the integration of the financial system. While such measures might not always reduce economic differentials in the short run, they do reduce the economic costs associated with such differentials and improve the resilience of economies to shocks, thus facilitating the transmission of monetary policy across the euro area.

FINANCIAL INTEGRATION AND FINANCIAL STABILITY

Financial integration is also relevant to the Eurosystem's task of contributing to the safeguarding of financial stability.⁴ The results of the ECB's monitoring activities in respect of euro area-wide financial stability are presented in its regular Financial Stability Review.

Financial system stability requires that the financial system's principal components – namely financial markets, the related infrastructures and financial institutions – be jointly capable of absorbing adverse disturbances. It also requires that the financial system facilitate a smooth and efficient reallocation of financial resources from savers to investors and that financial risk be assessed and priced accurately and managed efficiently. Inefficiencies in the allocation of capital or shortcomings in the pricing of risk can compromise future financial system stability and, therefore, also economic stability. Financial stability can also be affected by inefficiencies arising from an insufficiently integrated financial system.

It is therefore essential to understand the links between financial integration and financial stability. These links are of a twofold nature. On the one hand, more integrated financial markets offer better opportunities for financing and risk diversification, thus helping to improve the capacity of economies to absorb shocks. For example, cross-border banking broadens and deepens financial markets and increases liquidity and risk sharing. As the pool of available assets for investment is broadened, potentially enhancing the heterogeneity of financial institutions' portfolios, the ensuing wider spread of portfolio-related risks should reinforce the resilience and shock-absorption capacity of financial intermediaries, thus improving the soundness and robustness of an integrated financial system. On the other hand, financial integration implies a structural transformation of the financial system, including the creation of intensified cross-border financial links. As a result, the implications must also be assessed from the point of view of possible contagion effects. A thorough understanding of the effects of cross-border linkages in an increasingly integrated financial system is therefore crucial.

Overall, the effects of enhanced financial integration on the stability of the financial system can be expected to be positive in the long run. However, the structural transformation of the financial system through enhanced financial integration is another reason why the ECB closely monitors the financial integration process.

FINANCIAL INTEGRATION AND MARKET INFRASTRUCTURE

The implementation of the single monetary policy in the euro area is also affected by the degree of integration of the financial

³ See the articles entitled "Recent developments in financial structures of the euro area" and "Assessing the performance of financial systems" in the October 2003 and October 2005 issues of the Monthly Bulletin respectively.

⁴ Article 105(5) of the Treaty assigns the ESCB the statutory task of contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

infrastructures, namely the payment and securities clearing and settlement infrastructures. Payment and securities settlement systems are the main channels through which liquidity flows and securities are transferred to collateralise the Eurosystem's monetary policy operations. Furthermore, the financial infrastructures are of utmost importance to the stability of the financial system and can play a crucial role in the event of financial crisis situations. Only if financial infrastructures are adequately integrated can the financial system function smoothly.

The promotion of the smooth operation of payment systems is a basic task under the Treaty. The Eurosystem's interest in this respect extends to all facets of the financial infrastructures. This relates to large-value payment systems and securities clearing and settlement systems, given the increasing interdependencies between the payments and securities infrastructures, stemming, for instance, from the close relationship between the secured and unsecured money market. It also extends to the creation of integrated retail payment systems, in order to make the euro a truly domestic currency and to exploit the new possibilities offered by progress in information technology. Such modernisation of the European payments industry will ultimately also foster the further integration of the European financial sector (see also Section 4).

3 MONITORING THE STATE OF FINANCIAL INTEGRATION IN THE EURO AREA

Given its keen interest in European financial integration, as explained in the preceding section, the ECB closely monitors this process. For this purpose, the ECB has designed a basic conceptual framework, which is outlined below.

CONCEPTUAL ELEMENTS OF THE ECB'S MONITORING FRAMEWORK

In a first step, the ECB has adopted a definition of financial integration: the ECB considers the

market for a given set of financial instruments or services to be fully integrated when all potential market participants in such market (i) are subject to a single set of rules when they decide to deal with those financial instruments or services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market.

As described earlier, the financial system's principal components are financial markets, the related infrastructure and financial institutions. The ECB's definition of financial integration uses the term "market" in a broad sense, covering all possible exchanges of financial instruments or services, be it on an organised market, such as a stock exchange, or an over-the-counter market created by a financial institution's supply of a financial instrument or service. Furthermore, a financial market can never be fully integrated without the integration of the related market infrastructure, in particular payment and securities clearing and settlement systems. An overall assessment of the state of financial integration therefore requires an examination of all components of the financial system. In this sense, it should also be noted that the term "rules" as contained in the ECB's definition is used in a broad sense, including features such as laws and regulations, supervisory arrangements, market conventions, self-regulation, and standards and practices related to financial infrastructures. The wide coverage of the ECB's definition of financial integration is attributable to the fact that if only the first condition were fulfilled, i.e. the existence of a single set of rules for a given market, potential participants might still be discriminated against in terms of access to the market. Consequently, the ECB's definition includes a second condition whereby participants should not be discriminated against in their access to a market. The third condition for full financial integration is that once all potential market participants have accessed the market they should be treated equally when they operate therein.

Finally, it should be noted that while, in practice, financial integration is a process, the definition adopted by the ECB describes a state of full, or perfect, integration. By providing a benchmark against which to assess the state of financial integration, the definition can be used to underpin the ECB's analytical and empirical work.

In a second step, based on the definition adopted, the ECB has sought to devise a way to capture the state of financial integration in the euro area. In discussions on this topic, the arguments are often of a qualitative nature, stating the general need for enhancing financial integration in view of the related benefits. Nonetheless, quantitative measures provide the basis for an objective assessment of both the current level of financial integration and its evolution over time, i.e. whether integration is progressing, stagnating, or even regressing. Accordingly, the ECB published, in September 2005, an initial set of 20 indicators regarding the state of integration in euro area financial and banking markets. These indicators were compiled using both the statistics already collected and published by the ECB and data derived from market sources.⁵ This first publication covered the money market, the government and corporate bond market, the equity market and the banking markets, the latter encompassing wholesale and retail banking activities. The initial set of indicators will be extended, in particular by adding indicators related to financial institutions and infrastructures.

The current state of financial integration in the euro area is summarised below on the basis of selected published and forthcoming indicators.

THE STATE OF FINANCIAL INTEGRATION IN THE EURO AREA

While the euro has generally acted as a major catalyst for the integration of the euro area financial markets, the degree of integration differs from market segment to market segment, with integration being more advanced in those segments that are closer to the single monetary

policy, above all the money market. The rapid integration of the money market has also been supported by the establishment of the relevant payment system infrastructure, the TARGET system (see Section 4).

The unsecured interbank deposit market was almost perfectly integrated right at the start of Monetary Union, at which point the cross-country standard deviation of the average overnight lending rates among euro area countries was as low as 3 basis points. This has since fallen to just 1 basis point. Equally, the indicators both for longer maturities on the unsecured money market and for the repo market also show a very high degree of integration.

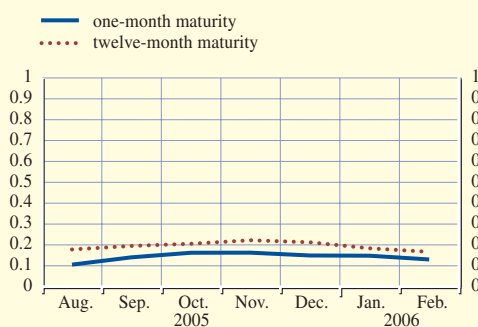
The decisive role of the euro in enhancing financial market integration is also visible from the interest rate derivatives markets. A particularly important segment is the euro interest rate swap market – including the euro overnight index swap market – which is now the largest interest rate swap market in the world. The launch of the EONIA Swap Index in June 2005 by Euribor FBE and Euribor ACI is evidence of both the importance and the further potential of this market segment. Chart 1 shows that, since the launch of that index, the cross-country standard deviation for EONIA Swap Index quotations at different maturities has stood at only 0.1-0.2 basis point, demonstrating the almost perfect integration of this market segment.

The least integrated money market segment is the short-term securities market. The European commercial paper and certificates of deposit markets are segmented in several market-places. However, progress is to be expected as a result of the Short-Term European Paper (STEP) initiative (see Section 4).

⁵ The publication was accompanied by an explanatory report, which is to be updated annually. For details of the indicators, see also the methodological notes in Annex 2 to that report. The indicators themselves are updated every six months. Earlier work on such indicators can be found in Baele, L., A. Ferrando, P. Hördahl, E. Krylova and C. Monnet (2004), "Measuring financial integration in the euro area", ECB Occasional Paper No. 14.

Chart 1 Standard deviation of average EONIA swap quotations across euro area countries

(61-day moving average; basis points)



Sources: European Banking Federation, ECB calculations.

The degree of integration of euro area government bond markets is very high, mainly owing to the disappearance of exchange rate

risk within the euro area and the convergence of inflation expectations across countries by the time the euro was introduced. Since then, government bond yields in different euro area countries have been driven mainly by euro area-wide factors and developments. One way of quantifying the degree of integration is to consider the standard deviation of bond yield spreads over time. The relevant indicator shows a significant drop in the run-up to Monetary Union, with the standard deviation remaining close to zero thereafter. Remaining differences between countries in terms of bond yields may be explained by differences in credit risk, in liquidity and in the availability of developed derivatives markets tied to the various bond markets. The box below looks at the relationship between financial integration and differences in credit risk.

Box**FINANCIAL INTEGRATION AND MARKET DISCIPLINE: THE EURO AREA GOVERNMENT BOND MARKET**

Market discipline may be broadly defined as the pressure exerted by market participants on different institutions, such as firms, banks and governments, to promote sustainable economic policies. This box focuses on market discipline with regard to governments. The bonds of governments following unsound economic policies are characterised by higher levels of risk. Risk-averse investors want to be compensated for bearing such extra risk and therefore demand higher yields. Governments have to take into account these higher financing costs when planning their economic policies. *Ceteris paribus*, market discipline provides a deterrent against unsound fiscal policies.

Market discipline is most effective in competitive and well-functioning markets. A necessary condition for financial markets to price sovereign bonds correctly is that governments have access to the capital markets on the same terms as other borrowers, and in particular that each country will ultimately bear the full costs of the credit risk implied in its government debt. Any direct or indirect pressure to favour government debt securities, or a perception in the market that a government with an unsustainable debt position would be bailed out, would inevitably introduce pricing distortions, thus impairing the role of the markets as a disciplinary device. The Maastricht Treaty explicitly recognises the importance of these issues in Articles 101-103.

If these conditions are satisfied (and there are no market failures), perfectly competitive markets will provide an accurate assessment of the risk/return profile of each bond. Under these

circumstances, market forces ultimately lead to funds being efficiently allocated in the most productive manner, with proper account being taken of risk. There is little doubt that the progress in financial integration witnessed in euro area government bond markets over the last few years has helped to improve the efficiency of financial markets in general and government bond markets in particular. By eliminating barriers to trade and creating a truly level playing-field, financial integration increases the level of competition in the financial markets, thus enhancing their capacity to accurately price assets. The observed integration of euro area government bond markets has therefore reinforced any market-driven disciplinary effect.

It is sometimes argued that the convergence in euro area government bond spreads which was seen in the run-up to EMU is evidence that the process of financial integration may be detrimental to the functioning of market discipline. This reasoning neglects the fact that spread convergence mainly reflected the closer coordination of monetary policies across euro area countries, an overall compression of risk premia also observable in other markets and outside the euro area, and the progressive elimination of uncertainty regarding exchange rate movements. Since 1999 spreads have mainly reflected liquidity and credit risks, which in turn reflect the sustainability of the countries' fiscal positions. The available evidence from credit default swaps suggests that countries with poorer fiscal positions do pay a higher premium, reflecting the higher risk of default, and that markets therefore continue to exert disciplinary pressure on governments.¹

¹ See the article entitled "Fiscal policies and financial markets" in the February 2006 issue of the Monthly Bulletin.

Prior to 1999 the euro area corporate bond market was open mainly to bond issuers with the highest credit quality ratings. Since then it has broadened to also meet the funding needs of riskier issuers. The degree of integration in the euro area corporate bond market is relatively high. The relevant indicators suggest that the country of issuance is of only marginal importance in explaining yield differentials.

Other market segments still have further potential for integration, such as the euro area equity market, which remains fairly fragmented. However, a gradual integration process is ongoing. For example, the ECB's indicators reveal that stock prices across the euro area are increasingly reacting to euro area-wide factors and developments. In addition, the elimination of currency risk within the euro area has encouraged integration in the sense that the "home bias" in the equity holdings of institutional investors has been significantly reduced. However, the country effect is still too important a factor to conclude that the euro area equity market is sufficiently integrated.

As regards securities markets such as bond and equity markets, the further integration of the underlying securities clearing and settlement infrastructure is of utmost importance. For example, while the number of central securities depositories declined from 22 in 1998 to 19 in 2005, with the number of securities central clearing counterparties declining from 14 to 7,

Chart 2 Number of payment and securities clearing and settlement systems in the euro area

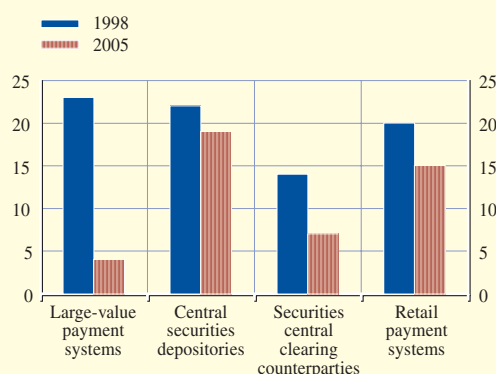
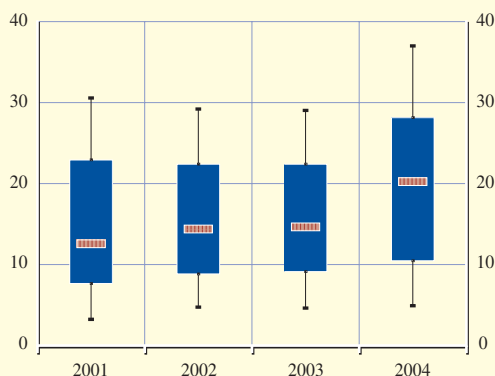


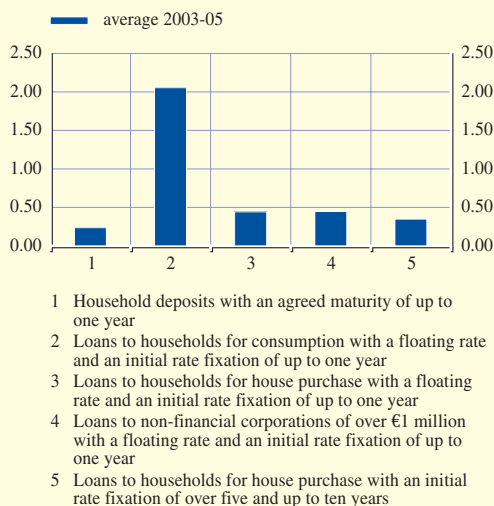
Chart 3 Dispersion of the assets of branches and subsidiaries across euro area countries

(as a percentage of the total assets of the banking sector)



Sources: ECB, Banking Supervision Committee.

Note: The lower and upper markers represent the minimum and maximum observations. Both have been corrected in order to offset the effect of possible outliers. The bottom of the box represents the first quartile and the top represents the third quartile. The brown line is the median across euro area countries.

Chart 4 Standard deviation of selected MFI interest rates across euro area countries

- 1 Household deposits with an agreed maturity of up to one year
- 2 Loans to households for consumption with a floating rate and an initial rate fixation of up to one year
- 3 Loans to households for house purchase with a floating rate and an initial rate fixation of up to one year
- 4 Loans to non-financial corporations of over €1 million with a floating rate and an initial rate fixation of up to one year
- 5 Loans to households for house purchase with an initial rate fixation of over five and up to ten years

Source: ECB.

Note: Countries in which the bank products in question are, in terms of volume, insignificant have not been included.

the number of securities clearing and settlement systems that are not efficiently connected to each other is still high. This contrasts, for example, with the significant progress that has been achieved in the integration of large-value payment systems, where the overall number has been reduced to 4, down from the 23 that existed before the introduction of the euro and the TARGET system. Chart 2 shows the developments over time in the number of payment systems and securities clearing and settlement infrastructures within the euro area.

Finally, as regards banking markets, one aspect that can be monitored with regard to the state of integration is the evolution of euro area cross-border banking. One possible indicator in this respect is the development over time of banks' branch and subsidiary structures across euro area countries. Chart 3 shows the development from 2001 to 2004 of the dispersion of the assets of banks' branches and subsidiaries across the euro area.

With regard to euro area banking markets, there is a difference, in terms of the degree of

integration, between capital market-related activities, interbank (or wholesale) activities and retail banking activities. For example, euro area cross-border interbank loans and holdings of securities have, in relative terms, experienced substantial growth since the late 1990s, pointing to a relatively high degree of integration in the wholesale segment. By contrast, integration in retail banking has not progressed to any great extent. In fact, there is evidence that there are differences in the impact of the money market rate on retail bank interest rates across the countries of the euro area, in terms of both level and changes over time.⁶ Chart 4 shows the cross-country standard deviation of interest rates for selected financial products. In particular, there are marked differences between individual euro area countries' interest rates on loans to households for consumption. While the cross-country standard deviation is smaller for the other financial product categories, it is not negligible.

⁶ See the article entitled "The use of harmonised MFI interest rate statistics" in the July 2005 issue of the Monthly Bulletin.

4 EUROSISTEM ACTIVITIES TO FOSTER FINANCIAL INTEGRATION

Analysis of the state of European financial integration and the monitoring of its progress over time are prerequisites for possible action with a view to reaping the full economic benefits of financial integration. Given its interest in the progress of European financial integration, the Eurosystem also helps to foster this process. In this respect, the ECB has defined four areas of activity in which the ECB and the Eurosystem can contribute to this process. These are detailed below, together with selected examples of ECB and Eurosystem initiatives.

MONITORING PROGRESS AND RAISING AWARENESS

The first contribution is to enhance knowledge and raise awareness of the state of and need for European financial integration, and to measure the progress made. The result of this is primarily the monitoring of the state of integration, inter alia on the basis of statistical indicators, as described in the previous section. A further contribution in this respect is the communication in speeches by Eurosystem representatives of the Eurosystem's stance and work on this matter. Furthermore, numerous research activities are being pursued by Eurosystem staff, together with academics, for example via the joint network of the ECB and the Centre for Financial Studies at the University of Frankfurt am Main on "Capital Markets and Financial Integration in Europe", and in cooperation with market practitioners.

ACTING AS A CATALYST

The second contribution is to act as a catalyst for private sector activities by facilitating collective action and assisting with possible coordination problems. As stated above, the process of financial integration is primarily market-driven. However, there can still be situations in which coordination problems occur, as incentives for market participants are not properly aligned. In such cases, market forces may not be able to drive financial integration forward. Collective action may

therefore be necessary in order to achieve progress. Given its unique institutional position of being both a public authority with a pan-European remit and, as a result of its basic tasks as a central bank, an active participant in the market with numerous relationships with other market participants, the ECB, together with the whole of the Eurosystem, can assume this crucial role as a catalyst.

As explained in Section 3, European short-term securities markets are fairly fragmented. Progress in integration is, however, expected as a result of the STEP initiative led by ACI – The Financial Markets Association, and the European Banking Federation (FBE). This initiative aims to promote the convergence of standards and practices through market participants' compliance with the STEP Market Convention, which covers disclosure, documentation, settlement and statistics.⁷ The European Financial Markets Lawyers Group⁸ has provided legal assistance for this market-led initiative. The Eurosystem has supported the STEP initiative since its inception. Specifically, the Eurosystem provides technical support for the labelling process for the first two years and the ECB produces statistics on yields and volumes in the STEP market, which are published on the ECB's website. These statistics are expected to play an important role in fostering the integration of the European short-term securities markets through greater market transparency.

A further example is the area of retail payments. As shown in Chart 2, by contrast with the developments in large-scale payment systems, the situation for retail payments today is nearly unchanged as compared with that prevailing before Monetary Union: in 2005 there were still

⁷ The STEP Secretariat's website (www.stepmarket.org) reports information on the STEP standards and the information memoranda for all STEP-labelled programmes.

⁸ The European Financial Markets Lawyers Group (EFMLG) was established in 1999 with a view to discussing the promotion of initiatives for enhanced harmonisation of European financial market activities. The members are selected from the EU credit institutions most active in European financial markets, namely the EURIBOR and EONIA panels. The group is chaired by the ECB.

15 different retail payment systems within the euro area, compared with 20 in 1998. The banking industry has, however, launched an initiative to create a Single Euro Payments Area (SEPA), which will enable European citizens, enterprises and public authorities to make payments throughout the euro area from a single bank account, using a single set of payment instruments, as easily and safely as in the national context today. In addition, national infrastructures will be migrated to a pan-European payments infrastructure characterised by complete interoperability between SEPA-compliant infrastructures. Sizeable financial benefits are expected from the integration of retail payments, as a result of standardisation and the opening-up of payment services markets to more competition. The Eurosystème supports this initiative and acts as a catalyst. High-level coordination takes place between the Eurosystème and the banking industry, and the ECB has arranged a number of meetings involving SEPA end-users.

An example of the catalyst role in the field of standard market legal documentation is the Master Agreement for Financial Transactions (the European Master Agreement (EMA)). The EMA is the first pan-European market standard for trading operations. It contributes to financial integration by permitting cross-border trading on the basis of a master agreement which is both a domestic and a pan-European standard. The EMA, which is a multilingual, multi-jurisdictional and multi-product master agreement, may be used to document repurchase agreements, foreign exchange, derivatives and securities loans, and generally serves to maximise cross-product netting and margining possibilities and to reduce documentation basis risk. The ECB participated in the drafting of the EMA and uses it for its relevant operations.

The ECB has also been involved in various European Financial Markets Lawyers Group initiatives regarding the harmonisation of netting provisions and securitisation legislation in the EU, rights evidenced by book entries and the provision of market guidance as regards

signing authorities for financial market participants.

PROVIDING ADVICE ON THE FRAMEWORK FOR THE FINANCIAL SYSTEM

The third contribution consists of providing advice on the legislative and regulatory framework for the European financial system. As noted earlier, although financial integration is primarily a market-driven process, an essential task that falls exclusively to public authorities is the setting-up of an effective legislative and regulatory framework that paves the way for further financial integration by establishing basic common rules and removing obstacles to cross-border transactions.

The Eurosystème regularly contributes in numerous areas related to EU financial services policy and financial regulation. In particular, it contributed to the European Commission's public consultation regarding the priorities for financial services policies over the next five years. In that contribution, the Eurosystème expressed its broad support for the Commission's general policy orientation, such as the need to pursue supervisory convergence and the need for consolidation and consistent implementation of the existing legislative framework for financial services, which should be achieved by exploiting the potential of the existing institutional set-up, such as the Lamfalussy comitology framework. The consultation on this Green Paper led the European Commission to publish, in December 2005, its "White Paper on Financial Services Policy 2005-2010". There has been a particular focus on the areas of clearing and settlement, retail banking (for instance mortgage credit) and investment funds. The Eurosystème also provided contributions to the Green Papers on the last two issues.

Furthermore, Article 105(4) of the Treaty stipulates that the ECB is to be consulted, in its fields of competence, on any proposed Community act and on any draft legislative provision proposed by national authorities. Specific examples in the area of financial integration are the Opinions adopted by the

ECB on the Collateral Directive and the proposal for a Council Decision concerning the signing of the Hague Convention on securities held with an intermediary.⁹

In addition, the Eurosystem fosters the integration, efficiency and security of the European securities clearing and settlement infrastructure. For example, the “Standards for Securities Clearing and Settlement in the European Union” were developed in cooperation with the Committee of European Securities Regulators (CESR).¹⁰ They promote a harmonised approach and are conducive to the integration of EU capital markets, placing emphasis on common solutions and interoperability between systems.

Finally, the ECB also participates in a number of EU committees carrying out work related to European financial integration, such as the Economic and Financial Committee, the Financial Services Committee and the regulatory and supervisory committees that have been set up under the Lamfalussy comitology framework.

PROVIDING CENTRAL BANKING SERVICES

The fourth contribution consists of providing central banking services that also foster European financial integration.

A very prominent example is the operation of the real-time gross settlement payment system for the euro, the TARGET system. In fact, the rapid integration of the euro money market, which is a sine qua non for monetary policy implementation, since only an integrated interbank market can ensure an even distribution of central bank liquidity and a homogeneous level of short-term interest rates across the euro area, has been supported by the establishment of the TARGET system, which has been operational since the very first day of Monetary Union. The launch of the single shared platform TARGET2, which is scheduled for November 2007, will further enhance financial integration, as it will provide a harmonised level of service

and a single price structure for domestic and cross-border payments.

Another example is the Eurosystem’s decision to gradually introduce a single list in its collateral framework for monetary policy operations as from January 2007 with the aim of replacing the current two-tier system of eligible collateral.¹¹ The single list should enhance the level playing-field in the euro area, further promote equal treatment for counterparties and issuers, and increase the overall transparency of the collateral framework for monetary policy operations. The decision in favour of the single list in the collateral framework therefore also underlines the Eurosystem’s determination to foster financial integration.

A further example of this kind of activity is the correspondent central banking model (CCBM) which exists for the cross-border transfer of collateral to the Eurosystem in addition to transfers via links between securities settlement systems. Initially, the CCBM was created as an interim model that would cease to operate as soon as the market had developed comprehensive and reliable alternatives. Today, however, it remains the main instrument for mobilising cross-border collateral in the context of the Eurosystem’s monetary policy operations.

5 CONCLUSION

This article provides an update of the ECB’s assessment of the state of European financial integration and reviews the various ways in which the ECB and the Eurosystem help to foster this process. In general, European financial integration is to be seen within the

9 CON/2001/13 of 13 June 2001 and CON/2005/7 of 17 March 2005 respectively.

10 See the ECB’s website at <http://www.ecb.int/pub/pdf/other/escb-cesr-standardssecurities2004en.pdf>. An update is foreseen by the end of 2006.

11 See the article entitled “The single list in the collateral framework of the Eurosystem” in this issue of the Monthly Bulletin.

context of the Lisbon strategy. Creating integrated, competitive and efficient financial markets is one key aspect of the Lisbon goals in order to fully exploit the benefits in terms of enhanced growth and employment. Of specific importance to the ECB and the Eurosystem is the fact that an integrated financial system is highly beneficial for the effective implementation of the single monetary policy within the euro area and the transmission of monetary policy impulses, for the task of contributing to the safeguarding of financial stability and for the smooth operation of payment and securities settlement systems.

Significant progress has been made in European financial integration over the past few years, fostered by the introduction of the euro. However, financial integration is, in particular, still lagging behind in the areas of retail financial services – both retail banking activities and payment system infrastructure services – and in the area of euro area securities clearing and settlement infrastructure.

While financial integration is, first and foremost, a market-driven process, it also requires an effective interplay between market forces and the actions of the public authorities. Examples such as the STEP and SEPA initiatives show that the private sector can contribute substantially to the integration of the European financial system. The ECB and the Eurosystem welcome such market-led initiatives and will continue to support them by acting as a catalyst.