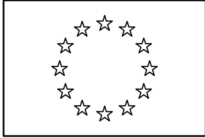

EUROPEAN UNION
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The EURO: Lessons for European and Asian Financial Markets

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SESSION 2: INTEGRATION AND REGULATION OF FINANCIAL MARKETS IN EUROPE

Financial Integration in the European Union

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1. Overall Developments

In recent years, there has been a visible acceleration in the process of development and integration of EU financial markets. There are three main, interrelated factors behind this acceleration: (i) globalization, fostered by the liberalization of international capital movements, financial deregulation and advances in technology; (ii) progress in creating a common regulatory framework across the EU (as part of the effort to complete the Internal Market in financial services), accompanied by financial reforms in the Member States; and (iii) the changeover to the euro.

As the previous session highlighted, before January 1999, the need to operate in many national currencies was a major obstacle to financial integration in the Union. By eliminating exchange-rate risk, the euro has removed the most significant barrier to the majority of cross-border financial transactions within the EU and at the same time has highlighted the opportunity costs of remaining sources of fragmentation in the system. The changeover to the euro spurred the integration of the EU financial markets, but the degrees of integration vary across market segments.

2. Money and Derivatives Markets

In the *market for unsecured inter-bank deposits,* integration is virtually complete and there is practically full convergence in very short-term interest rates across the euro area. Such convergence in interest rates is also reflected in the full acceptance by market operators of EONIA (Euro Overnight Index Average) and EURIBOR (Euro-InterBank Offered Rate) as uniform price references. Interest rate convergence has also been helped by the efficient distribution of liquidity area-wide as cross-border transactions account for a large part (about (60%) of total inter-bank activity of the largest market participants.

The euro-area *derivatives market* is also highly integrated. The cross-border market for euro interest rate swaps has expanded sharply since the introduction of the euro, and the high degree of market integration is reflected in very narrow bid-ask spreads and relatively large outstanding amounts. Overall, the total of euro interest rate OTC derivatives contracts reaches a daily turnover larger than the US dollar segment.

The *secured money market* segments (e.g., private repurchase agreements, Treasury bills, commercial paper and certificates of deposit, which involve the exchange of liquidity for collateral) remain considerably less integrated. This state of affairs reflects differences in market practices, regulations and tax/legal treatments in these markets as well as in the use of collateral. These national differences are reflected in segmented national-based market infrastructures and can create important practical difficulties in cross-border clearing and settlement. However, various recent initiatives are expected to foster market integration and efficiency – for instance the STEP (Short Term European Paper) project which will foster convergence of standards and practices in the commercial paper market or the

improvements made to cross-border repo transactions (eg the introduction of electronic links between Clearstream and Euroclear, the creation of a internationally tradable collateral basket, and the use of tri-party repos).

3. Bond Markets

The introduction of the euro has integrated the national bond markets of the participating Member States, resulting in a substantially more homogenous euro-denominated bond market. The effects of integration are evident in many aspects of market activity.

First, the greater liquidity and depth of the euro-denominated market has been reflected in higher issuance volumes. Total domestic issuance in euro since January 1999 has exceeded the combined issuance in legacy currencies during the years immediately preceding EMU. Issuance expanded to a record level of nearly €1.8 trillion in 2003 and stabilized near this level since then.

Second, the increased homogeneity of the euro-area government bond market is evident in highly convergent yields across the Member States, in marked contrast to the situation that existed in the mid-1990s. The convergence in yields can be attributed to the elimination of exchange risk, to the convergence of inflation expectations across Member States, and to the relative improvement in budgetary conditions in several of the Member States, though the perceived deterioration in the credit quality of some borrowers (Italy, Greece and Portugal) has recently been reflected in a moderate spread widening. There is however still evidence of fragmentation of liquidity in this market segment, as government bonds are issued by twelve separate agencies with different borrowing requirements, issuance strategies, procedures and instruments.

Third, relative to the pre-EMU situation, there has been a sharp rise in the share of private sector relative to sovereign issuance. This shift in the composition of bond issuance is the result of both reduced financing needs of the euro area governments following the 1990s fiscal retrenchment, and a surge in issuance by financial and non-financial corporations. In particular, the relatively underdeveloped market in non-financial corporate bonds has recorded exceptionally rapid growth rates until 2001, when corporate issuance was disrupted by international tensions and the revelation of accounting scandals. Since then, the receptiveness of investors for corporate bonds has again improved, but issuance remained relatively limited due to the efforts of corporations to consolidate their balance sheets. Meanwhile, the rise of issues by lower-rated corporations is an indication of a maturing market, although the share of high-yielding issues remains relatively small.

As issuance volumes have risen, the euro has emerged as the second most important currency for international bond issuance after the US Dollar. When domestic currency issues targeted at international investors is included, the euro has even slightly overtaken the US dollar with regards to the share of debt securities outstanding.

4. Equity Markets

The integration in EU equity markets has been evident mainly in a more sectorally correlated movement in equity prices across the various Member State markets. Though some 'home bias' remains in equity holding, institutional investors' behavior has changed away from country-based investments and toward sector-based investments, with divergence in the evolution of indices explained mainly by differences in composition. The use of equity related derivatives has also significantly increased in recent years, enhancing primary equity market liquidity.

The response of formal stock exchanges to increased competition has been to consolidate. While consolidation has been a global rather than Europe-specific phenomenon, there have been several high-profile consolidation efforts in Europe. The most notable of these have been the integration of Nordics and Baltics stock exchanges into OMX and the creation of Euronext, which merged the Amsterdam, Brussels and Paris exchanges and the Lisbon exchange. As trading exchanges consolidate, EU post-trading infrastructure remains highly fragmented. Historically, the pattern of European securities trading has followed national lines, resulting in efficient structures for securities transactions at the national level, usually with the vertical integration of the trading, clearing, settlement and depository functions. These nationally based structures – offering only very limited scope for cross-border trading – have by and large survived until today. The various national systems use specific market practices and are subject to different frameworks for the regulatory, legal and fiscal treatment of securities. This state of affairs causes significant additional costs for cross-border securities trading in the European Union. The safety and efficiency of securities clearing and settlement systems are crucial elements for the proper functioning and the competitiveness of capital markets and for the implementation of monetary policy. Work on removing the barriers to efficient cross-border clearing and settlement, as identified by the Group headed by Alberto Giovannini lies currently at the heart of the Commission's efforts to promote an integrated EU capital market.

5. Financial Intermediaries

The impact of financial integration has also extended to the activities of financial intermediaries. While retail banking remains largely domestic, the market for corporate finance services in Europe is increasingly open to global competition. In some activities, such as bond and equity issuance, as well as syndicated lending, domestic intermediaries have been loosing ground with respect to EU - and US - competitors.

The most visible response of financial intermediaries to the competition intensified by the introduction of the euro has been consolidation. Consolidation has been accompanied by a restructuring process and a reorientation of activities from "traditional" bank lending towards "investment banking" style activities. This reorientation in banks' activities has enhanced financial market intermediation by creating and selling new capital market products or advising clients on the pricing and structuring of a merger or acquisition. As a result, there has been a shift in bank revenue flows from interest income to non-interest income (fees and commission), and reduced reliance on deposits in favour of securities issuance.

Consolidation among financial intermediaries has so far taken place mainly within national boundaries, implying a significant increase in industry concentration at the national level particularly in the smaller Member States. However, cross-border mergers and acquisitions have not been insignificant and have shown an increasing trend, and a high degree of foreign ownership is typical for the financial intermediaries in the New Member States. Because the significant differences in national legal and regulatory environments (e.g., consumer and competition laws) make a pan-European product range impractical at present, the scale and scope of economies from cross-border mergers would seem to be less than those from domestic mergers. Cultural factors, differences in the framework for corporate governance and taxation also tend to discourage cross-border consolidation. The Commission is analyzing the obstacles to cross-border mergers and acquisitions and will propose some policies to address them.

6. The way forward

EU financial integration is crucial for enhancing the growth potential of the EU economy. In an integrated market, savers and investors benefit from broader choices at lower transaction costs. At the macroeconomic level, this translates into higher saving, investment, productivity, and eventually economic growth. Economic studies on the likely impact of financial integration on the EU economy have concluded that financial integration would bring substantial and durable benefits. This is why successive European Councils have established the integration of EU financial markets as a priority of economic reform in the EU.

The introduction of the euro has been a major factor in speeding up integration. However, even with the euro in place, the objective of a single financial market still remains to be achieved. The implementation of the Financial Services Action Plan, the blueprint for EU financial integration will be a further significant step. As the measures contained in it have now been adopted at EU level and are being transposed in the national legislation of the Member States, the focus is now on improved transposition, enforcement and continuous evaluation. Some additional carefully targeted measures may however be necessary to remove the remaining economically significant barriers. I will however not expand on this issue which will be the topic of the next panellist.