Financial Integration in Europe, Today

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Three points in my presentation

• A “new role” for financial integration?

• Elements from the ECB Financial Integration Report

• Where we stand, and the way forward
The “new role” of financial integration

Traditional arguments (period 1999-2007):

- Efficient single capital market (financial integration fosters market efficiency and lowers cost of capital)
- Ensuring smooth transmission of monetary policy
- Eurosistema involvement: Treaty provisions, definition of financial integration, mission statement, policies, monitoring

More recently (period 2008-...):

- The traditional view is still valid, but is not complete
- Two-way links between financial integration and financial stability
Financial integration and financial stability

• See ECB Report 2010, Special Feature D

• In short:
  ✓ Financial integration can increase market volatility by facilitating contagion across institutions and markets
  ✓ Risks stemming from under-regulated financial sector and from a mix of banking and securitisation
  ✓ Abrupt capital reversals, liquidity dry-ups
  ✓ In turn, financial instability endangers financial integration by reintroducing cross-country segmentation
ECB Report
Financial Integration in Europe 2010
Money markets: sharp interest rate divergence

Standard deviation of the EURIBOR

I-month

(basis points)

12-month

Standard deviation of EUREPO rates

1 month

(basis points)

12-month

Source: ECB Financial Integration Report
Unsecured money markets: renewed disintegration is concentrated in some specific countries

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

Sources: EBF and ECB calculations. Note: 61-day moving average; basis points, Cut-off period, end-September 2010.
The impact of the crisis on government bond markets has been strong and heterogeneous.

**Ten-year government bond yield spread vis-à-vis the German government bond**

(daily data; basis points)

Source: ECB Financial Integration Report
Equity markets integration steadily rising over time, especially in the euro area

Cross-border equity holdings by euro area residents
*(share of total holdings)*

Source: ECB Financial Integration Report
Banking integration: impact on retail markets

- The crisis has reversed the trend towards cross-border integration and interest rate convergence. Recent signs of return to normality.

Source: ECB Financial Integration Report
Where do we stand

- The crisis had disruptive effects on financial integration. Differences across market segments
- Two phases: the banking crisis (September 2008-April 2010); the sovereign crisis (May 2010-…)
- The crisis also eroded the public support for financial integration and financial development generally

**Conclusions of the ECB Report 2010:**

- Financial instability resulted from weak regulation and supervision (+ macroeconomic conditions)
- Integrated capital markets played a reinforcing role
Going forward

- There is a powerful link between sovereign risk and risks in the financial sector:
  - Government bonds play a central role in the collateral process
  - Governments are the ultimate regulators and guarantors of the financial systems (as long as fiscal policy remains national)
- Reform of euro area governance rules is critical also for restoring financial integration
- In turn, restoring financial integration is critical for the proper functioning of the euro
Additional slides
Motivations for involvement (Treaty art. 127):

- Conduct of single monetary policy
- Smooth operation of payment systems
- Without prejudice to the objective of price stability, support general economic policies of the Community
- (Also: Contribute to safeguarding financial stability)

Eurosystem 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 financial integration...”
A financial market is fully integrated when all potential market participants …

– Are subject to the same set of rules, and …

– have equal access to this market, and …

– are treated equally when they operate in this market.
ECB/Eurosystem contribution to financial integration

1. **Advice on legislative and regulatory framework:**
   - Examples: The new supervisory architecture

2. **Catalyst for private sector activities:**
   - Examples: SEPA, STEP

3. **Enhancing knowledge and awareness:**
   - Examples: Financial Integration Report, statistics, research

4. **Providing central banking services:**
   - Examples: TARGET2, T2S