Good news and bad on Europe's financial markets integration

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The euro has had a very positive impact on Europe's financial markets, writes **Jacques de Larosière**, a former Managing Director of the International Monetary Fund and Governor of the Banque de France. But there is much still to do before the full benefits can be felt
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This article sets out to assess the integration of financial markets in Europe, and to analyze the reasons why these markets are still more fragmented than is desirable. But to begin with the more positive developments, it is now clear that the creation of the single currency has fostered the emergence of a vast international euro financial market. The euro's share of official reserves held by central banks around the world has almost doubled since 1999, and the end of 2003 accounted for 19.7% of total official reserves, as against 63.8% for the US dollar. So although it has not yet become a major reserve currency, or a payment instrument in the trade of goods and services, the euro has rapidly gained equal footing with the dollar as a currency of issue.

In the bond market, the euro has effectively exceeded all expectations. It has been the main force behind the surge of the euro international financial market, whose size has more than quadrupled since 1998, going from €733bn then to €1,550bn in 2004. Eurozone countries' government bonds have created a huge market. In the past six years, the volume of their new bond issues has largely exceeded that of the US Treasury in Europe.

Euro-denominated international issuances have also exploded over the past few years. To gauge the international significance of financial markets, one has to determine the amounts of bonds issued by corporations, utilities and financial institutions as well as governments and supranational bodies on external markets, meaning those outside their local area of residence. Such issues in euros have literally taken off over the past years. From January 1999 to the end of last year, international bonds issued in euros by "non-residents" amounted to €3,888bn. During the same period, US denominated international issuances reached €4,267bn. Over the last six years, the € ratio has thus reached 91% of the $ level in cumulative terms, and the trend is moving in favor of the euro because European international issues have traditionally accounted for only 20-30% of comparable issues in the United States. The same trend also goes for non-financial corporates. Gross issuances in euros are now close to US levels. When it comes to bond issues as a whole, meaning domestic governments and international issuers, the comparative figures across the Atlantic are spectacular; the eurozone's bond market is now higher than the US market.

Also, the volume of outstanding bonds denominated in dollars was predominant until 2002 because of the weight of existing bonds; this picture has now changed dramatically. As of September last year, 44.7% of outstanding international bonds were denominated in euros, against 39.2% in dollars. Significantly, total new gross issues denominated in euros now exceed the US level. Thus, from the beginning of 1999 until end-2004, total gross Euro-denominated bond issues by governments and international entities totaled €7,240bn, as against the $6,809bn worth of issues denominated in dollars during the same period.

"Non-resident" financial institutions and large global corporations headquartered in the United States and the United Kingdom are choosing to issue 80% of their bonds in euros. A breakdown by currency and by country of issuance shows that the role of the euro has also strengthened outside the European market, so that the share of net international securities, both bonds and money market instruments issued in euros on the US market went from 9.6% in 1999 to a respectable 29.4% in the first quarter of 2004. The share of net securities issued in dollars in European markets is only 10.8%, having dropped from 25.9% in 1998. Meanwhile, the average size of eurozone issuances has almost trebled, going from €150m in 1997 to more than €430m in 2004, with a similar trend in the United States.

The scale and significance of these changes have to be underlined. The euro bond market has considerably expanded and it is now a vast and certain source of cash for European and global companies, just like the US market. From that standpoint, we are experiencing a new situation, that of a bipolar international financial market. That also means that financing methods have substantially changed in Europe. Instead of a financing model in which banks are the most predominant intermediates, European companies are increasingly interested in market financing sources. The trend is far from having reached its limits. The size of Europe's securitization reserve should provide great support to the euro bond market, given that outstanding debt securities issued by non-financial corporations in the eurozone represents around 5% of GDP, compared to more than 20% in the US.

Equity Markets

Although they have risen sharply since the 1980s, equity markets in Europe are still less developed than in the United States. In terms of GNP, stock market capitalization in the European Union is still significantly lower than in the US. But stock market link-ups, the quality of the electronic platforms and the growing importance of European indices are positive factors, making it possible to carry out risk analyses that are more sector-oriented and less national. There is no doubt that a growing number of European companies are turning to the stock markets to help them to grow, and that a larger segment of non-European investors are acquiring euro stocks.

At the same time, the composition of households' financial assets in the EU shows that equity holdings, including mutual fund shares, rose between 1995 and 2002 to 25% of the total, and remained stable in the US at just over 40%. All this shows that although equity and share issues are not as developed in Europe as in the US as a means of household savings and of financing the economy, things are gradually catching up.

What lessons can be learnt from the European experience? First the advent of the euro as a common currency, and the development of a vast and liquid euro financial market, has had substantial positive consequences for Europe. It has led to a major increase in the issuance of bonds from corporates, be they European or internationally based. And this has been accompanied by a unification of long-term interest rates within Europe. Spreads among European countries have almost disappeared. In this regard, the economic benefits stemming from the sizeable drop in long-term rates reported in a number of countries, should not be underestimated. Until 1997, the differences in interest rates noted in Europe on 10-year bonds often exceeded 500 to 600 basis points. Now they have been virtually eliminated.

The creation of the euro has also removed, by definition, foreign exchange risks within the eurozone. This is a fundamental innovation, and has turned out to be both a source of commercial and financial integration and of increased competition due to greater price transparency as well as a source of economic stability.

When one recalls the exchange rate volatility that was still commonplace in Europe just a few years ago, and how sensitive European countries were to external crises and the risks that this erratic behavior brought to bear on the very existence of the Single Market, one can only be struck by the radical change the introduction of the euro has had on the way markets operate.

All in all, we can say that the introduction of the euro, combined with the intense efforts to coordinate economic policies that for a number of years preceded Economic and Monetary Union (EMU), was a significant factor of convergence within the eurozone. There has clearly been a concrete move towards convergence of inflation rates as well as bond yields. The convergence was towards the best situation of the time, namely that of German bonds for long-term rates.

But much remains to be done to achieve the full benefits of a truly integrated financial market in Europe. Europe needs a framework whereby competition is free of legal, regulatory, tax and technical obstacles between countries, and investors' protection is real and based on some common principles.

Europe, under the prodding of the European Commission and with the implementation of its Financial Services Action Plan, is moving in that direction. But, there are still substantial impediments.

Differences in national rules

National regulations too often impose specific rules on financial products and their access to markets. This makes cross border transactions more complex, burdensome and costly, and has a negative impact on corporates and investors who should be able to operate in a truly European "domestic" market.

Although bond markets are pretty well integrated (the prospectus Directive provides a relatively efficient common ground), retail operations as well as wholesale banking activities are still very much governed by specific national regulations. This is true for retail banking and financial services, electronic payment instruments and consumer protection. Europe still needs to achieve:

- A "European passport" that allows fund managers to sell their financial products across the EU without needing to create a subsidiary company in each host country.

- A set of common core principles for the protection of consumers and investors.

Europeans have failed to agree to the substantial harmonisation of national laws governing financial transactions, and the concept of mutual recognition carries serious risks of distorting competition between domestic operations and their cross-border competitors. So the creation of a "26th regime", a body of European core rules for investor and consumer protection that would be offered as an option particularly for savings and pension fund products, seems to be a fruitful new regulatory approach.

But more progress is also needed on tax harmonization as an important condition for financial market integration and on the implementation of a European Company Law, and on a corporate governance system that would provide an agreed set of rules governing takeovers, bankruptcy laws and so on.

Fragmentation of financial markets infrastructures

Europe has a myriad of stock exchanges and clearing and settlement institutions, which of course adds to the cost and reduces the efficiency of market transactions. It is up to the market actors to fashion a more efficient and productive system, and things are very much in a state of flux.

Intense market competition has so far led to several levels of consolidation, with Euronext resulting from a merger of the French, Belgium, Dutch and Portuguese stock markets and at regional level the OM Group in Scandinavia. Traditional stock markets are being obliged to regroup, and it is a process that will surely continue. But at present post trading arrangements within the EU are also complex and fragmented, with more than 25 settlement institutions still active throughout Europe. The situation imposes extra risks and costs on issuers, investors and intermediaries that are variously estimated at between €1.6bn and €5bn a year.

There remain deep concerns and fierce disagreements about how to ensure fair competition. The fact that there is so much discussion about governance arrangements in Europe shows that we are confronted by a real problem. The best way of handling both core post trading activities and commercial ones lies at the heart of the debate, and the challenge remains that of interlinking post trading activities in a way that also ensures effective competition between them. These disagreements are, to say the least, slowing down European integration, and financial markets across the EU have so far failed to resolve this crucially important problem.

Regulatory and supervisory harmonization

Each nation in Europe has its own system of regulation and supervision, so to avoid too many discrepancies a process of coordination has been put in train in the securities sector called the Lamfalussy Process, after its creator the distinguished Belgian central banker Alexandre Lamfalussy. This process has led to the creation of two committees, one at regulator level the other at enforcement level, and has also focused attention on the need for better communication inside the financial services industry before the establishment of new rules.

This mechanism is working reasonably well in the securities field, and is being extended to the insurance and the banking sectors. But I personally believe Europe should go further. Two points should be made:

- On the Lamfalussy process, we must do all we can to make it an unalloyed success. The concept of a "lead supervisor" is of great importance, but one should not discard a possible future need for an adequate European system of regulation and surveillance if progress in cross-border transactions calls for it.

- Given the growing interlinkage between all segments of the securities markets and their financial intermediaries, systemic risk can only be dealt with at EU level involving the European Central Bank.

Although the creation of the single currency and the years of economic convergence that preceded it have considerably boosted the dimension and depth of European financial markets, much remains to be done. The European Commission calculates that the further integration of EU financial markets would boost economic growth by more than 1% over the next decade, reducing the cost of capital by some 0.5%. But financial market integration is not by itself a panacea. It entails more interconnections between financial intermediaries and therefore increases their exposure to common shocks. In today's global economic and financial system, rules and risk assessment mechanisms should be consistent worldwide.

A more meaningful and balanced transatlantic dialogue on regulatory and accounting issues is therefore of the essence. Harmonization of accounting systems is certainly desirable, but not at any cost. And changes in banks' accounting rules should not, for the sake of harmonization or doctrinaire considerations, lead to more financial volatility or weaken the banking intermediation business model that has proved its efficiency in continental Europe.

Nor can financial integration be a substitute for structural reform. EU countries must address their fiscal problems stemming from excessive public spending, and they must tackle the issues of their health and pension systems. The real challenge is to increase our potential growth rate and to use European savings in efficient and innovative investments. The euro's long-term success, Europe's social and political stability, and its global influence greatly depend on the way these structural advances are implemented, and that in turn will reflect the speed and the quality of the dialogue that shapes them.