EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB's Report on
Financial Integration in Europe 2012

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Overview of the Financial Integration Report

Main purpose: The report monitors financial integration in Europe in all key financial market segments, using a standard set of indicators.

Main focus this year: the impact on financial integration resulting from the intensification of the sovereign euro area bond market crisis

Structure of the report:

- Key messages of the state of financial integration in key financial market segments
- Chapter 1: Assessment of state of financial integration in the euro area
- Chapter 2: Special Features on single topics
  - analysis of overall benefits of financial integration (A)
  - analysis of effects of weaker financial integration on monetary policy transmission (B) and operational framework (C)
  - analysis of impact of institutional reforms in European Union (D)
  - development of aggregate and sector imbalances in euro area (E)
- Chapter 3: Eurosystem activities aimed at fostering financial integration

Key messages from the Financial Integration Report

- The **intensification of the European sovereign bond market** crisis in 2011 has led to a **further deterioration of the degree of euro area financial integration**:
    I. secured and unsecured money markets have become increasingly impaired
    II. corporate bond markets experienced severe tensions
    III. equity and banking markets have been less affected relative to other markets

- **These developments do not detract from the significant benefits for households and corporations of the progressive financial and monetary integration over the last 25 years**. In recent years, the financial crisis has led to a loss of part of these gains in some members of the euro area.

- It is essential to keep the objective of European financial integration through enhancements of the Single Market Programme; the **strengthening of the euro area policy frameworks;** the strict implementation of the current institutional reforms, constituting a first step towards a fiscal union; and the development of an enhanced European banking supervision and resolution. These initiatives will be conducive to a better environment for financial integration to proceed.

Money market integration – setback mirrors stress in sovereign debt markets

- In 2011, the cross-sectional standard deviation of **unsecured** EONIA lending rates across euro area countries has risen sharply (chart on the left). This pattern is linked to the sovereign debt risk.
- Nevertheless, in aggregate terms, the amounts of interbank lending to other non-domestic euro area countries did not markedly decrease (charts on the right).

Interbank loans: share of outstanding amounts by residency (%)

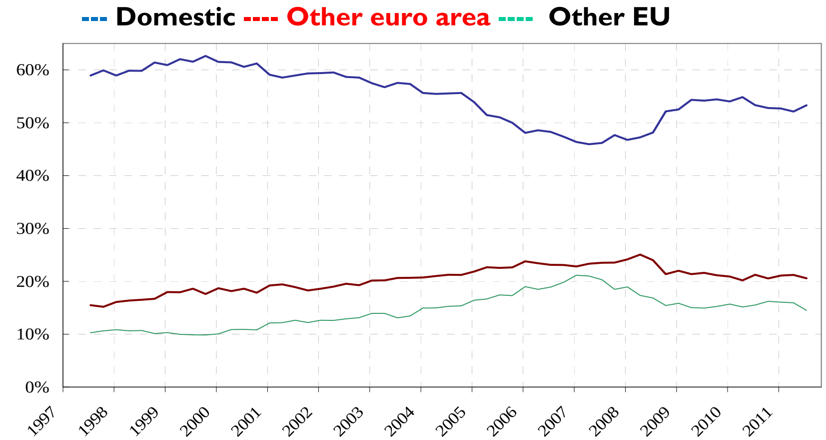
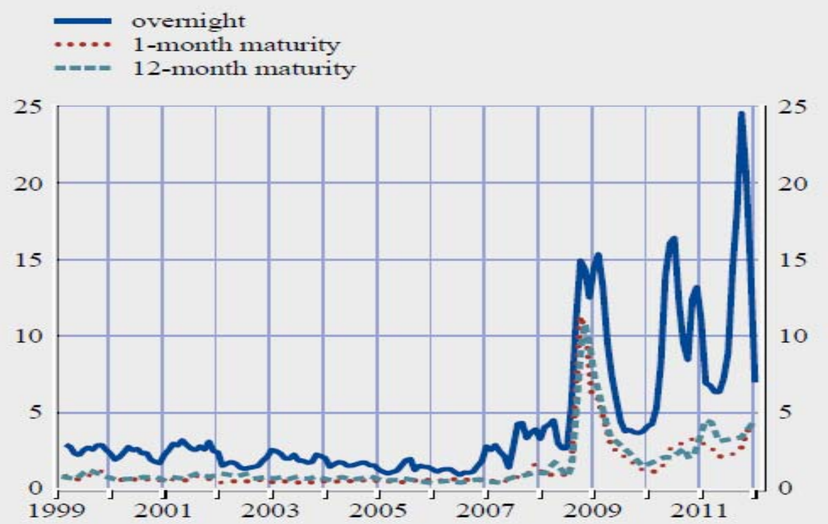


Chart 3 Cross-country standard deviation of average unsecured interbank lending rates across euro area countries

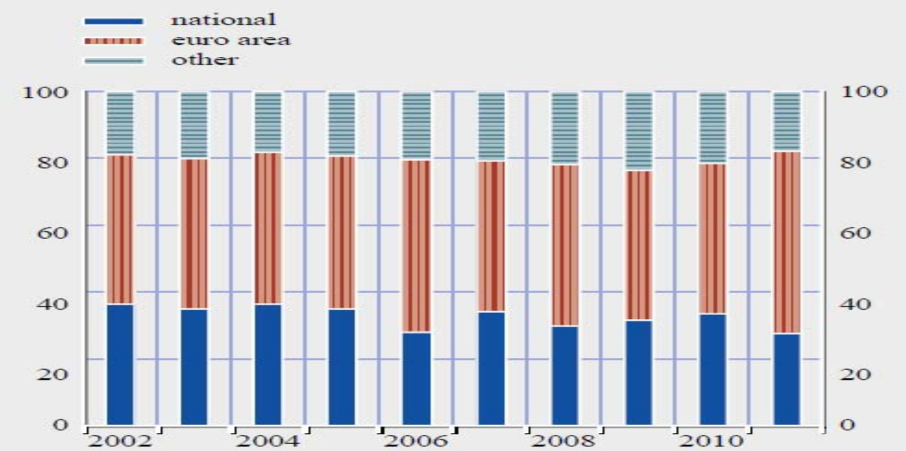
(61-day moving average; basis points)



Sources: EBF and ECB calculations.

Chart 6 Geographical counterparty breakdown for secured and unsecured transactions

(percentages)

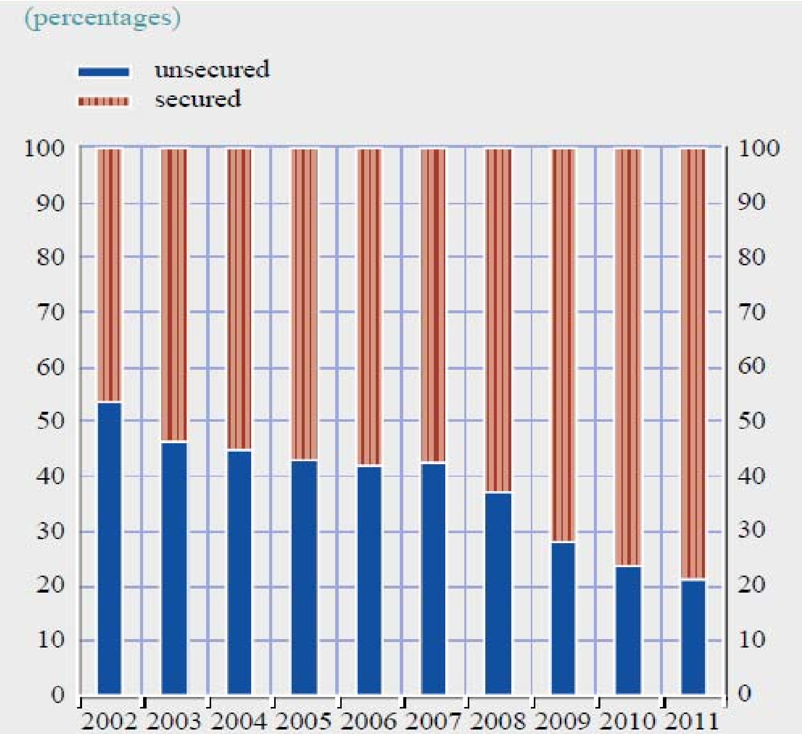


Source: Euro Money Market Survey.

Money market integration – setback mirrors stress in sovereign debt markets

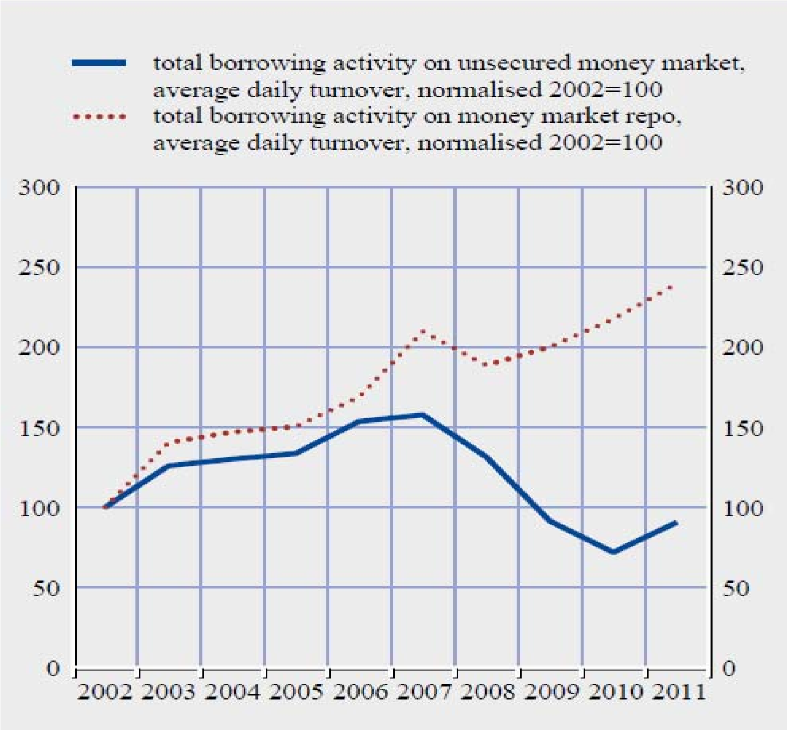
- Although the share of other non-domestic euro area countries in total lending by EA banks did not decreased in aggregate terms in recent years, the split into secured and unsecured lending shows that it was the secured lending that increased to offset the decline of the unsecured part of the market. This result is linked to heightened credit risk concerns.

Chart 7 Breakdown of secured and unsecured transactions executed with non-domestic counterparties in the euro area



Source: ECB's Euro Money Market Survey 2011.

Chart A Borrowing activity in the euro area secured and unsecured markets



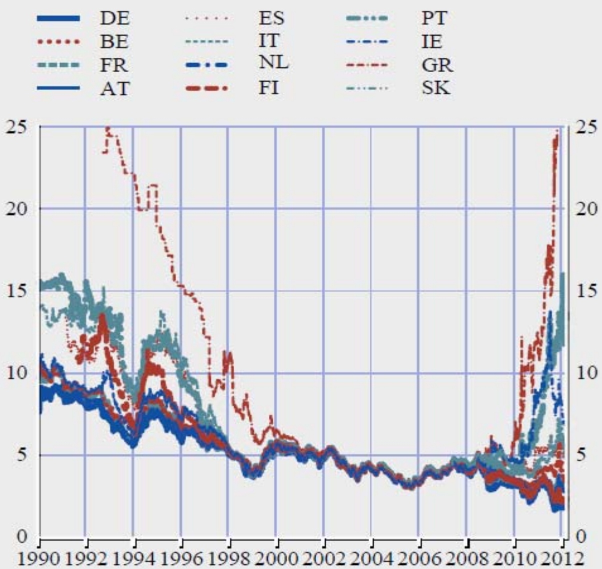
Source: Euro Money Market Survey.

Bond market integration hit by severe tensions in 2011, giving rise to concerns of systemic nature

- Euro area **sovereign bond yields** have diverged further, overall, in 2011 (chart left).
- **Corporate bond markets** have also experienced significant tensions, both in the financial and non-financial sectors. Country-level effects have become more important in driving yield developments (chart in the middle and on the right side).

Chart 10 Euro area ten-year sovereign bond yields

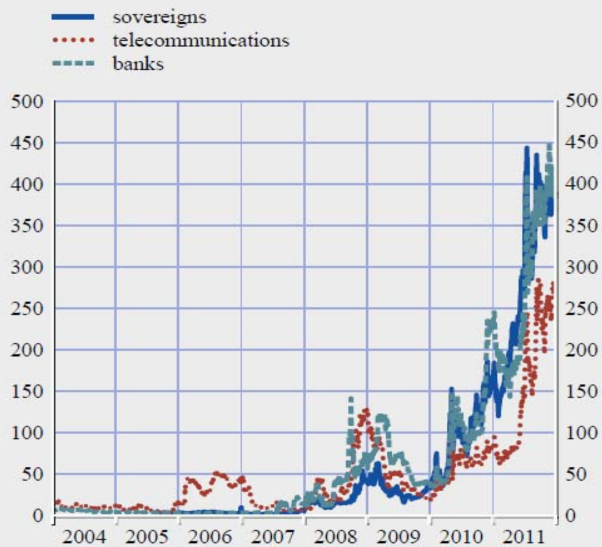
(weekly averages; percentage points)



Sources: Thomson Reuters and ECB.
Notes: The chart presents the yields of euro area sovereigns for the country composition as in 2011. The yields for Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent or a lack of observations. Last value for Greece: 31% (not shown).

Chart 15 Dispersion in five-year CDS premia across euro area countries

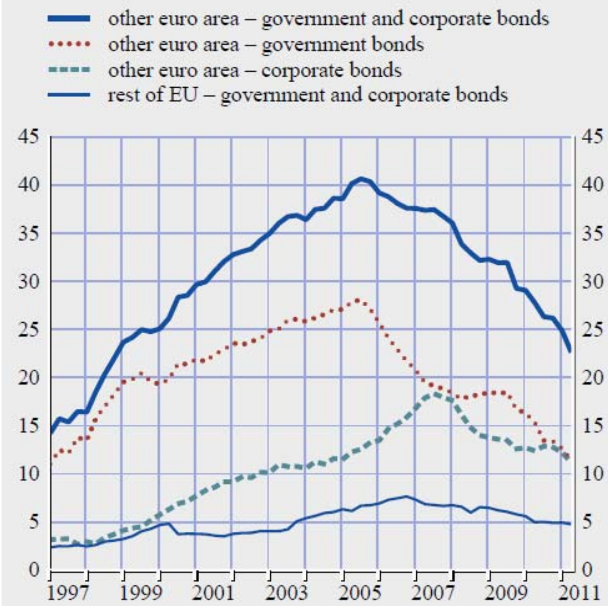
(daily data; basis points)



Sources: Thomson Reuters and ECB calculations.
Notes: The data do not include Greece and Ireland. Greece is excluded owing to very high sovereign CDS premia, and Ireland is excluded owing to the very high CDS premia of its telecommunications company. All sectors are presented for this smaller sample to ensure comparability. The results for the full sample are presented in Chart C8 in the Statistical Annex.

Chart 14 Share of MFI cross-border holdings of debt securities issued by euro area and EU corporates and sovereigns

(share of total holdings, excluding the Eurosystem; percentages)

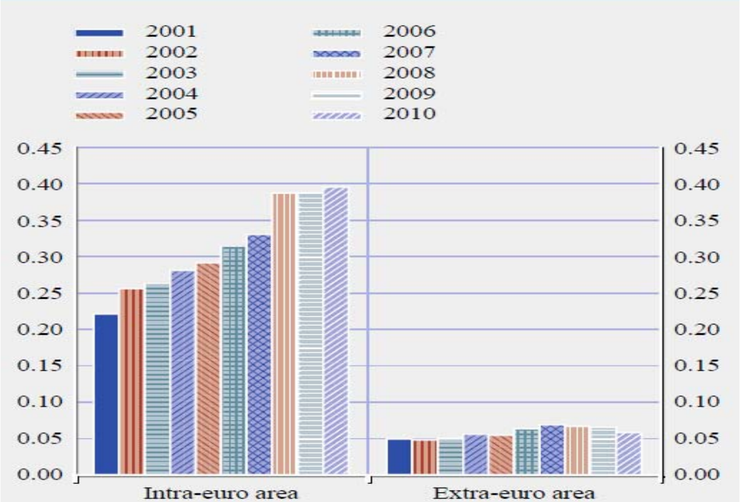


Source: ECB.
Note: Outstanding amounts are classified by the residency of the issuer.

Equity market integration – apparent more limited impact of sovereign crisis

- **Cross-border holdings are not displaying significant discrimination with regard to the country of origin**. Also national stock price indices seem to be reacting without an overwhelming country-specific influence.
- The degree of cross-border holdings of equity issued by euro area residents has increased steadily over the last decade (left chart). Equity holdings held by investment funds have declined only slightly since the beginning of the financial crisis, but are still higher than before the introduction of the common currency (right chart).

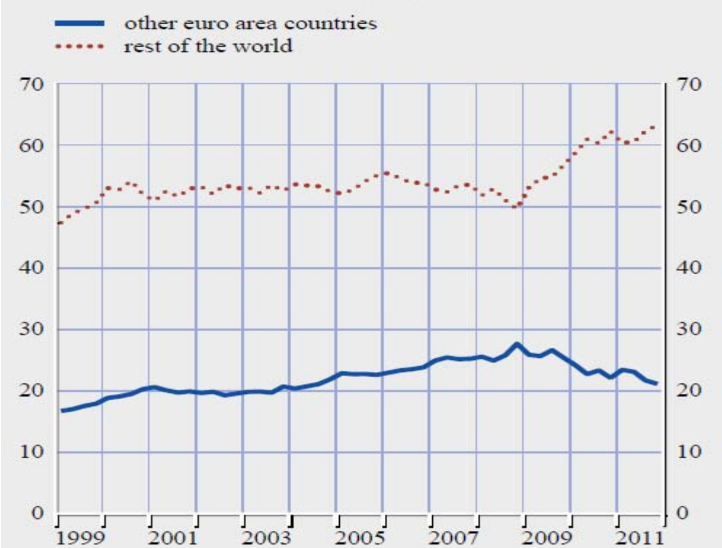
Chart 22 The degree of cross-border holdings of equity issued by euro area residents



Sources: IMF, Thomson Reuters and ECB calculations.
Notes: Intra-euro area is defined as the share of equity issued in the euro area residents and held by residents of other euro area countries (excluding central banks). Extra-euro area is defined as the share of euro area equity held by non-residents of the euro area (excluding central banks).

Chart 23 Investment funds' holdings of equity issued in other euro area countries and the rest of the world

(as a share of total holdings of equity)



Source: ECB.

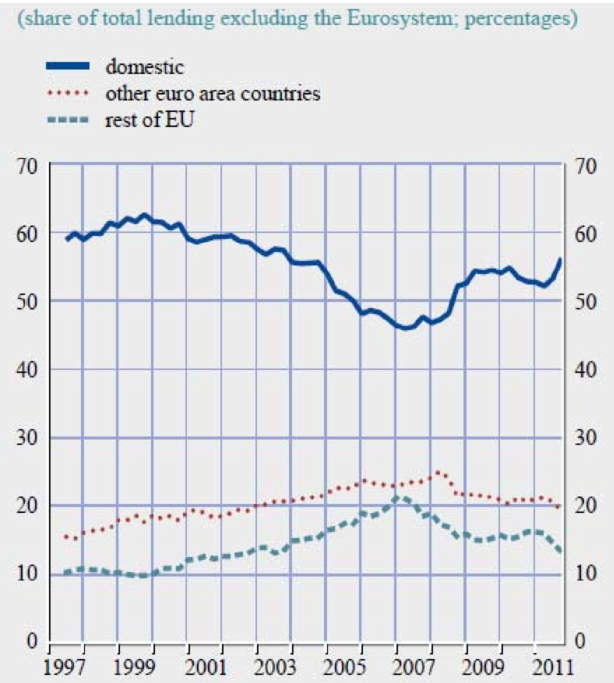
Bank Credit market integration – mixed signals

- The indicators of the **euro area banking market integration** generally signalled a lower pace of deterioration during the financial crisis, relative to other markets. However, there is evidence suggesting a slow erosion of the earlier progress towards financial integration.

- The left chart shows that the **share of domestic lending activity**, which had declined from 61% in 1999 to 46% at the onset of the financial crisis in 2007, has increased again although without attaining the earlier level

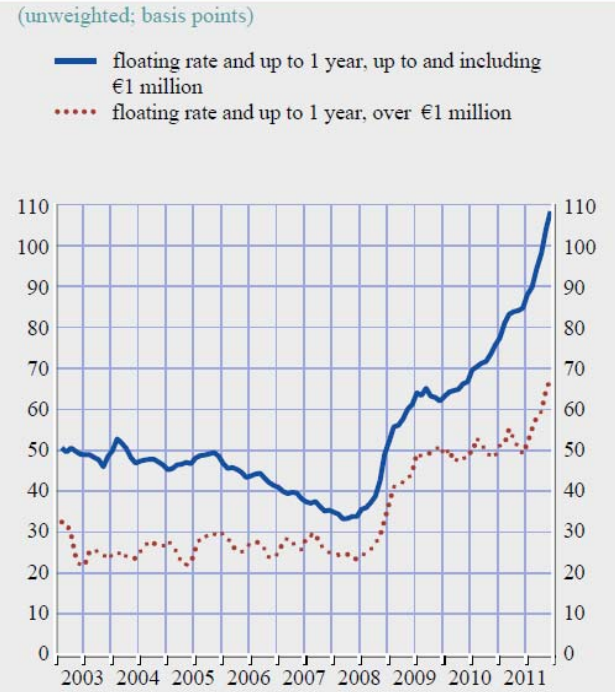
- As regards **short-term loans**, the rise in price dispersion has steadily increased throughout the crisis, suggesting particularly strong market fragmentation in the corporate retail market segment (right chart).

Chart 25 MFI loans to MFIs: outstanding amounts by residency of the counterparty



Source: ECB.

Chart 27 Cross-country standard deviation of MFI interest rates on new loans to non-financial corporations



Source: ECB.

Quantifying the expected impact of the EU's Single Financial Market

The integration of the European market for financial services has been a **gradual but successful process stretching over the last few decades.**

It was expected that financial market integration will have a **positive impact on economic performance** in the EU. **Quantitative analyses** predicted this:

•**Cecchini Report (1988)[1]:** The reduction in the prices of financial services would increase the value added in financial services by 0.7% of GDP.

•**London Economics (2002)[2]:** The study predicted inter alia an increase in EU real GDP of 1.1% in the long run.

•**CEPR researchers (2002)[3]:** One main conclusion is that valued-added growth in the EU manufacturing sector would increase by between 0.75 and 0.94 %-points.

1 Cecchini, P., Catinat, M. and Jacquemin, A. (1988), The European challenge 1992, the benefits of a single market, Wildwood House.

2 London Economics (2002), Quantification of the Macro-Economic Impact of Integration of EU Financial Markets – Final Report to the European Commission – Directorate-General for the Internal Market, available on the Commission's website (http://ec.europa.eu).

3 Gianetti, M., Guiso, L., Jappelli, T., Padula, M. and Pagano, M. (2002), "Financial Market Integration, Corporate Financing and Economic Growth", European Economy, Economic Papers, No 179, European Commission, available on the Commission's website (http://ec.europa.eu).

Quantifying the impact of the EU's Single Financial Market: Benefits for households

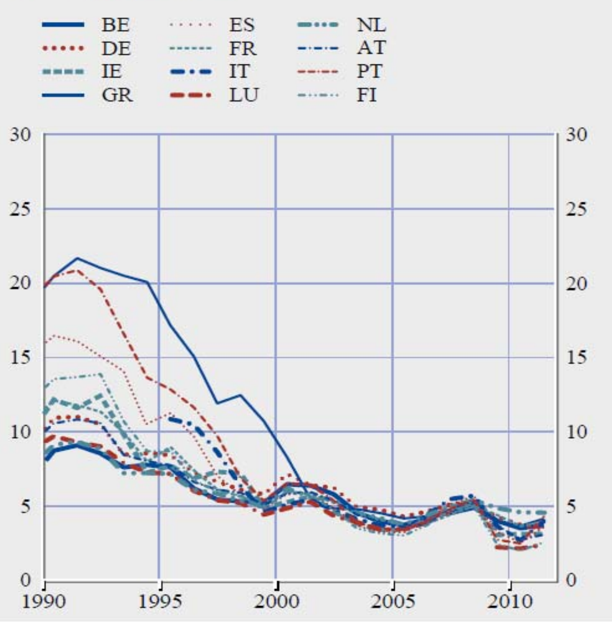
- Indeed, the monetary and financial union had an **overwhelming effect on financial integration**, for example on the interest rates for house purchases. Lower financing costs for such purchases offer substantial benefits.

- The left chart shows that residential mortgage rates have declined over the last decades to below 5% for most of the time since the introduction of the common currency.

- Since late 2008, a wider dispersion of financing rates across countries is clearly visible (right chart). But compared to the long-term development, this dispersion seems to be rather small.

Chart 30 Interest rates on new loans to households for house purchase in euro area countries

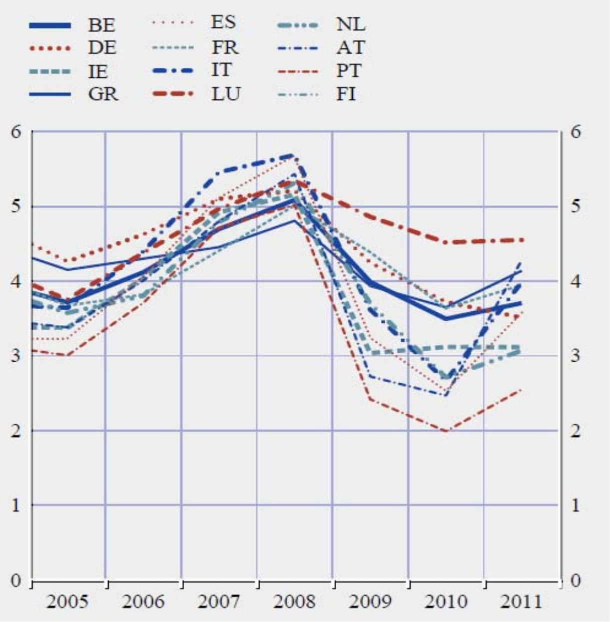
(percentages per annum)



Sources: ECB and national sources.
Notes: A precise definition of this loan category can be found in the notes to Table 1. Data prior 2003 are based on non-harmonised estimates.

Chart 32 Interest rates on new loans to households for house purchase in euro area countries

(percentages per annum)

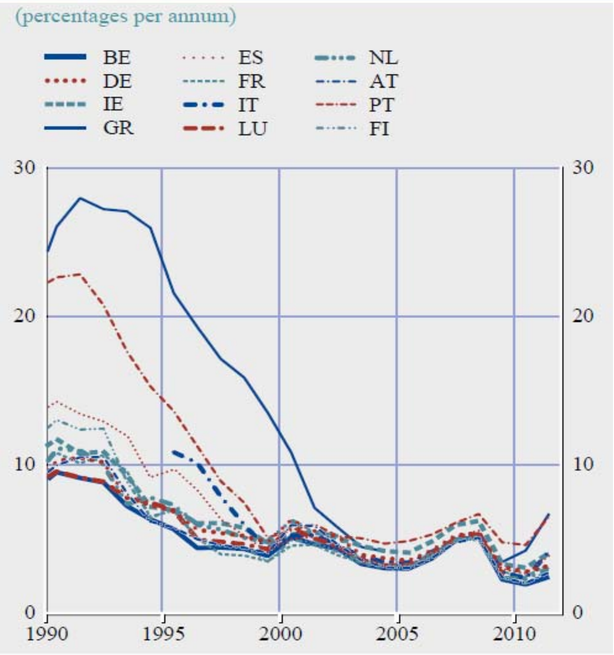


Sources: ECB and national sources.
Notes: A precise definition of this loan category can be found in the notes to Table 1.

Quantifying the impact of the EU's Single Financial Market: Benefits for corporations

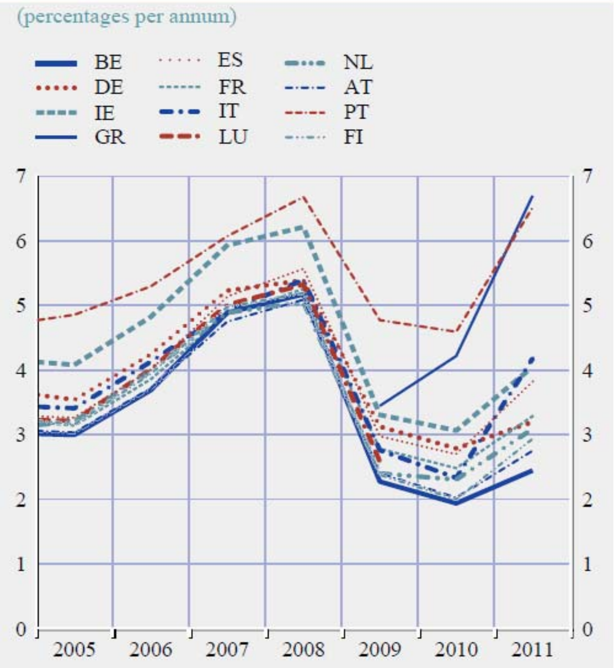
- **European non-financial corporations have also experienced much lower financing costs**, with declines similar in magnitude to those for residential mortgages. This may have contributed to higher investment, employment and growth, thereby further benefiting all European economic agents.
- To better illustrate these benefits, the left chart provides a long historical series of the rates charged to corporations on new loans.
- The pattern is similar to the residential mortgages: a sharp decline since the 1990s, and a wider dispersion of new loans for corporations since 2008 (right chart).

Chart 31 Interest rates on new loans to euro area non-financial corporations



Sources: ECB and national sources.
Notes: A precise definition of this loan category can be found in the notes to Table 1. Data prior 2003 are based on non-harmonised estimates.

Chart 33 Interest rates on new loans to euro area non-financial corporations



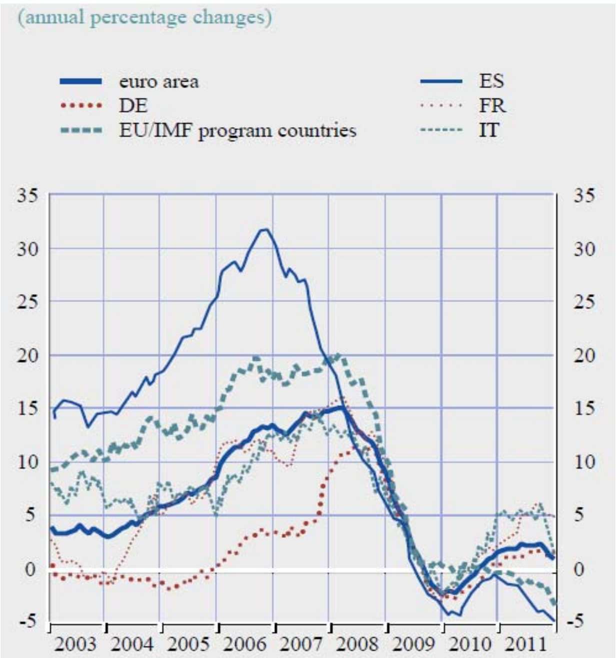
Source: ECB and national sources.
Notes: A precise definition of the loan category can be found in the notes to Table 1.

Effects of weaker financial integration – examples for heterogeneous country developments

- Substantial heterogeneity across countries is reflected in an **increase in cross-country dispersion in loan growth** after the middle of 2011 following the re-intensification of the sovereign debt crisis (left chart).

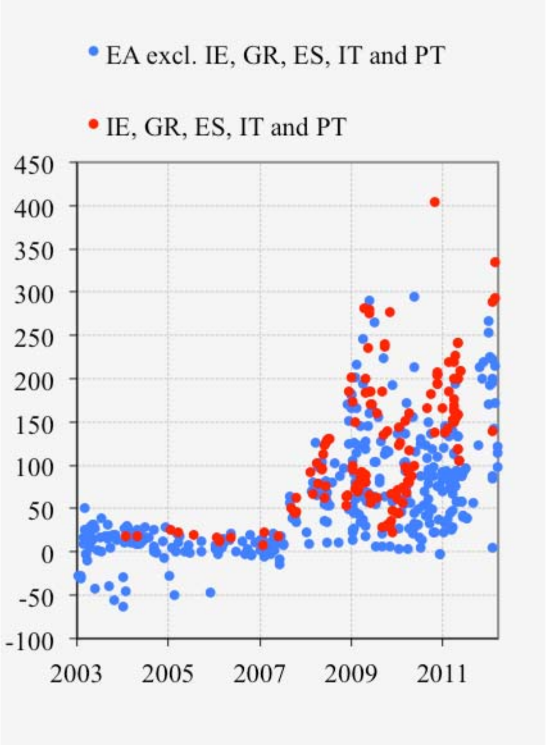
- There are also signs of country dependent price differentiation in the primary market for banks' long-term debt. For example, in 2009 bonds backed by government guarantees were cheaper to issue, with only small differences related to the country of issue. In 2011, the **cost of issuing bonds in the primary market was clearly dependent on the country of origin** (right chart).

Chart 44 MFI loans to NFCs



Sources: ECB and BSI.
Notes: Adjusted for securitisation, assuming no securitised loans to NFCs before 2009. Latest observation: January 2012.

Bank bond spreads at issuance by country group



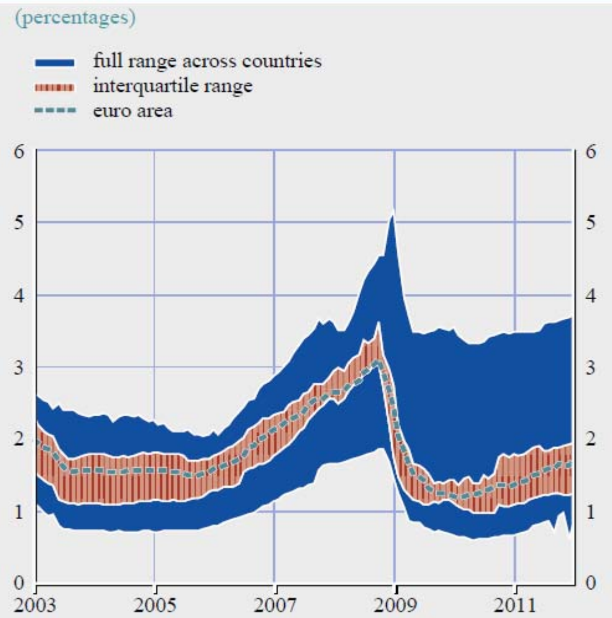
Effects of weaker financial integration – on the transmission of monetary policy

- Some evidence in the deposit markets points to strong **differentiation in banks' cost of funding across the euro area, which may be passed on to their customers in the supply and price of credit** offered by these banks (left chart).

- The right chart shows the ongoing segmentation of various money market rates and the interest rates charged by MFIs on short-term loans.

- This may affect the **relative importance of the EONIA and MRO rates in determining the retail lending rates of banks and thus imply that monetary policy impulses are transmitted differently in the euro area countries.**

Chart 38 Interest rates on MFI deposits for households in the euro area



Sources: ECB and ECB calculations.
Notes: The deposit rates are aggregated using outstanding amounts. Latest observation is January 2012.

Chart 40 Relationship between the MRO, EONIA and three-month EURIBOR rates and interest rates on MFI loans to NFCs (MIR)

Source: ECB.
Notes: MRO (dotted reddish brown line) is the main refinancing operation rate set by the Governing Council of the ECB. MIR (dashed petrol blue line) is the MFI interest rate charged to NFCs on new loans with an initial rate fixation period of up to one year. EONIA (thick blue line) is the average euro area overnight unsecured money market rate. 3M EURIBOR (thin blue line) is the average interest rate at which euro area banks offer to lend each other unsecured funds at three months.

Effects of weaker financial integration – consequences for monetary policy transmission and the operational framework

Effects on monetary policy transmission:

•Significant impairment of the monetary policy transmission channels in the euro area as a result of the sovereign debt crisis.

•High degree of heterogeneity across countries and cases of severe distortion of monetary policy transmission. This has provided the motivation for several unconventional monetary policy measures the Eurosystem took and that have mitigated, to a degree, the negative impact of the impaired transmission.

Consequences for the Eurosystem's operational framework:

•The framework has proven to be flexible enough to adjust well to difficult conditions and effective in mitigating some of the effects of the deterioration in financial integration.

•However, the framework has limits: it can neither address the root causes of the deterioration nor completely offset its effects. The solution of the sovereign crisis lies with the member states and the economic governance framework of the euro area.

Conclusions

Conclusions

•The financial crisis has led to a marked deterioration in European financial integration. Nevertheless, it is important to acknowledge the benefits that have resulted from financial integration coming from European initiatives during the past 25 years.

•The pre-crisis inadequacies of the EU financial and institutional framework played an important role in undermining the stability and integration of the euro area financial sector during the crisis. **Current reforms** in the EU, regarding the fiscal compact, the macro imbalances procedure and the size and scope of financial backstops, have the potential to create positive momentum to overcome the crisis.

•Looking forward, it will be also crucial that the current regulatory and supervisory initiatives are completed at the EU level. For the euro area, a resolution authority, including or combined with a resolution fund, should be "moved up in the agenda" (ESCB Opinion on the Commission's consultation paper about bank recovery and resolution, May 2011)