One Money, No Market
The débâcle of European financial integration

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Bruegel and ECB

Bruegel, 26 April 2012
Homeward bound
Economist, 21st April 2012
Cross-border bank exposure

Economist, 21st April 2012

Jeux sans frontières
Cross-border banking claims on the rest of the economy, change on previous year, $trn

Diminishing northern exposure
Banking-system exposure to euro-area peripheral countries*, $trn

Source: Bank for International Settlements
*To Q3 annualised

Source: Bank for International Settlements
*Cyprus, Greece, Ireland, Italy, Portugal and Spain
1. Some concepts
2. Documenting the débâcle
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Defining financial integration

**ECB:** “A market [...] is integrated if all potential market participants with the same relevant characteristics: (i) face a single set of rules [...] ; (ii) have equal access to [...] financial instruments and services; (iii) are treated equally when they are active in the market.” (“institution-based” definition: equal market access de jure & de facto)

**Pagano et al. (2002):** “…when the law of one price holds” (empirical definition, price-based)

**Lane-Milesi Ferretti (2003):** If there are large/growing cross border asset holdings (empirical definition, quantity-based)

(Different definitions. Conceptual and empirical problems)
Pros & cons of financial integration

Pros:

• consumption smoothing, risk sharing; diversification
• large pool of finance supporting investment and growth;
• efficient use of scarce financial resources;
• policy discipline

Cons (major emphasis after the recent crisis):

• enhancing financial complexity
• destabilizing capital flows
• cross-border contagion
Steps of regional integration (Balassa 1961, Sapir 2011):

- **Free trade area** (*removal of internal barriers*)
- **Customs union** (*common external tariffs*)
- **Common market** (*free mobility of labour & capital*)
- **Economic union** (*policy harmonisation to avoid discrimination*)
- **Full integration** (*common monetary, fiscal, social policies; supranational authority prevails over national decision-making*)

Financial integration (*capital mobility*) is an element, among many, of regional economic integration
Padoa-Schioppa (2002): “As a central bank we are interested in further financial integration within the euro area because this would enhance the effectiveness in the transmission of the single monetary policy to the real economy. Of course, just as important for us are the broad economic benefits of integration ...”

“The introduction of the single currency [...] represents a powerful catalyst to complete the integration process in the financial industry. The multiplicity of currencies in the single market was in fact a fundamental factor of segmentation...”

(Two-way relation between financial integration and the single monetary policy)

Complementary roles of:

✓ **Commission (Markt & Ecfin):** Single Market regulation, financial supervision; consumer protection, ...

✓ **ECB:** Payments and settlement systems, market surveillance, monetary policy operations, legal opinions, advice, ...

(Financial integration in the EU or in the euro area?)
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Euribor spreads, domestic and cross-border

Chart 5 Standard deviation of the EURIBOR

(61-day moving average; basis points)

- cross-country
- intra-country
- difference

1-month maturity

12-month maturity
Eonia and repo rate spreads

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 4: Cross-country standard deviation of average interbank repo rates across euro area countries
(61-day moving average; basis points)

Sources: EBF and ECB calculations.
Migration to the repo segment

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


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

Source: Euro Money Market Survey.
Selected 3-month repo rates

Chart B 3-month indicative market repo rates on German, Italian and Spanish government bonds

(percentages)

Sources: Bloomberg and Commerzbank.
Chart 3 Cross-country standard deviation of average unsecured interbank lending rates across euro area countries

(61-day moving average; basis points)
Money market vs. sovereign spreads

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

Chart 10: Euro area ten-year sovereign bond yields

Sources: EBF and ECB calculations.

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).

Sources: Thomson Reuters and ECB.
Credit risk spillovers (euro area)

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.
Bond market spillovers (EA vs. US)

**Chart 47: Sovereign and Telecom CDS premia – Euro Area**

(basis points; 2 January 2010 – 31 December 2011)

- x-axis: sovereign CDS premia
- y-axis: telecom CDS premia

- 2010 Q1
- 2010 Q2
- 2010 Q3
- 2010 Q4
- 2011 Q1
- 2011 Q2
- 2011 Q3
- 2011 Q4

Sources: Thomson Reuters and ECB calculations

Notes: Each chart presents the daily observations of telecom and sovereign CDS premia, marked for days in various quarters over the observation period. Euro area values are computed as the weighted averages of sovereign (or telecom) CDS premia of individual countries, where weights correspond to the ECB capital key.

**Chart 48: Sovereign and Telecom CDS premia – United States**

(basis points; 2 January 2010 – 31 December 2011)

- x-axis: sovereign CDS premia
- y-axis: telecom CDS premia

- 2010 Q1
- 2010 Q2
- 2010 Q3
- 2010 Q4
- 2011 Q1
- 2011 Q2
- 2011 Q3
- 2011 Q4

Sources: Thomson Reuters and ECB calculations

Notes: Each chart presents the daily observations of telecom and sovereign CDS premia, marked for days in various quarters over the observation period.
Re-nationalisation of bond holdings

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

Chart 13 Investment funds’ holdings of debt securities issued in other euro area countries and the rest of the world

Source: ECB.
Note: Outstanding amounts are classified by the residency of the issuer.
Re-nationalisation of central bank collateral

Chart 54 Cross-border activity in the posting of Eurosystem collateral

(percentage shares of total collateral)

- Other
- Domestic use
- Cross-border within the euro area

Source: ECB.
Note: The share ‘other’ which is neither allocated to domestic nor to euro area collateral includes issuances from other EEA, G10 and supra-national entities.
Equity markets: lesser impact

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

- 2001
- 2002
- 2003
- 2004
- 2005
- 2006
- 2007
- 2008
- 2009
- 2010

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)

- Other euro area countries
- Rest of the world

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).
Bank retail credit: slow deterioration

**Chart 26 MFI loans to non-MFIs: outstanding amounts by residency of the counterparty**

(share of total lending excluding the Eurosystem; percentages)

- Other euro area countries
- Rest of EU

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

(unweighted; basis points)

- Floating rate and up to 1 year, up to and including €1 million
- Floating rate and up to 1 year, over €1 million

Source: ECB.
Overview

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Monetary transmission through banks

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

(Percentages)

- Full range across countries
- Interquartile range
- Euro area

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

Chart 49 Composite MFI interest rate on loans to households across euro area countries

(Percentages per annum)

- Full range
- Interquartile range
- Euro area

Sources: ECB and ECB calculations.
Notes: Composite rate aggregated using outstanding amounts. Latest observation is January 2012.

Chart 46 Composite MFI interest rate on loans to NFCs across euro area countries

(Percentages per annum)

- Full range
- Interquartile range
- Euro area

Sources: ECB and ECB calculations.
Notes: Composite rate aggregated using outstanding amounts. Latest observation is January 2012.
Credit trends: from boom to crunch

Chart 44 MFI loans to NFCs

(annual percentage changes)

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

Chart 45 Changes in credit standards applied to the approval of loans or credit lines to enterprises

Chart 50 Changes in credit standards applied to the approval of loans or credit lines to households for house purchases

Sources: Eurosystem’s BLS and ECB calculations.
Deficit countries (before crisis): Ireland, Estonia, Greece, Spain, France, Italy, Cyprus, Malta, Portugal, Slovakia, Slovenia
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The financial crisis has led to a marked deterioration in European financial integration. After the ECB 3-year refinancing operations, financial integration showed some signs of improvement (temporary?)

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

Progressive integration over last quarter century – from Cecchini report (1988) to today – has led to substantive benefits for households and corporations. The crisis is cancelling part of these gains.

The enhancements of the Single Market Programme, the strengthening of the euro area policy frameworks regarding prudential supervision as well as macroeconomic and fiscal policies accompanied by policy actions at national level, need to be brought forward.

The completion of the current institutional reforms, constituting a first step towards a fiscal union as well as an even more European set-up of supervision, is desirable as it should contribute to a better environment that can surpass the crisis.
1. Can a single monetary policy be conducted without financial integration?
   ✓ No historical precedents; no “doctrine”
   ✓ “Communicating vessels” don’t communicate: liquidity allocation policy matters
   ✓ Implications for the Eurosystem operational framework

2. Adjusting market structures?
   ✓ Credit risk insurance schemes, central counterparties, …
   ✓ Role of governments vs. central banks

3. The role of euro area governance
   ✓ How fast will institutional changes already undertaken (fiscal compact, excessive imbalance procedure) help?
   ✓ “Eurobonds”