Financial integration and the international role of the euro

panel remarks by

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Institute for International Economics
Euro at Five: Ready for a Global Role?

Disclaimer: Any views expressed are only the author’s own and do not necessarily reflect the views of the ECB or the Eurosystem
Outline

• European financial integration
  – Some concepts: financial system and integration
  – Dimensions of financial integration
  – Recent trends in money markets and the situation in the securities settlement industry
  – Initiative: ECB-CFS research network

• The international role of the euro
  – Historical experiences with international currencies
  – Economic factors at work
  – Some early evidence: money markets and trade invoicing

• Conclusions
Some concepts

• Financial system: Set of markets and intermediaries through which households, firms and governments channel available savings to investment opportunities.

• The financial system performs three main functions:
  – financing;
  – payments and settlements;
  – screening and monitoring.
Some concepts (cont.)

• Financial integration (negative, snapshot):
  – Absence of friction that discriminates agents in their access to financial products on the basis of their location.

• Financial integration can then be defined, more generally, as a process leading to the removal of the relevant frictions and obstacles.

• Financial integration (positive):
  – The market for a given set of financial instruments or services is fully integrated if all potential market participants with the same relevant characteristics (i) face a single set of rules when they decide to deal with those instruments and services, (ii) have equal access to the above mentioned set of instruments or services, and (iii) are treated equally when they are active in the market.
European integration more generally

• Single market program:
  – 1992 etc.

• Economic and Monetary Union (EMU):
  – Stage 3: start of the single currency (January 1999)
  – A single currency is an important component of a common financial system and a strong promoter of financial integration, but it is not sufficient

• Financial Services Action Plan (1999-2004):
  – 42 legislative measures
  – Ensure three objectives: (i) a single EU market for wholesale financial services; (ii) open and secure retail markets; (iii) state-of-the-art prudential rules and supervision

• What’s next? “Post-FSAP agenda”
Dimensions of financial integration

• Financial markets
  – Money markets
  – Bond markets
  – Loan markets

• Financial institutions
  – Banks
  – Investment companies
  – Mutual funds, pension funds
  – Insurance companies

• Related payments, clearing and settlement infrastructures

• For the remainder: focus on money markets and settlement systems
Money market integration

EURIBOR and EUREPO cross-country over within-country rate deviations

Deposit market

Repo market

Source: Baele et al. (forthcoming), using European Banking Federation data
Money market integration

Euro-area cross-border interbank lending (stocks)

Source: Gaspar et al. (2003), building on Galati and Tsatsaronis (2001) and BIS data
## Financial Integration in the Euro Area - Infrastructure

### Developments in euro area payment and settlement systems

<table>
<thead>
<tr>
<th>Large-value Payment Systems</th>
<th>Securities Settlement Systems</th>
<th>Retail Payment Systems</th>
<th>Clearing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>24</td>
<td>13</td>
<td>2</td>
</tr>
<tr>
<td>18</td>
<td>24</td>
<td>13</td>
<td>2</td>
</tr>
<tr>
<td>consolidation of 11 RTGS systems into TARGET</td>
<td>mergers, consolidations</td>
<td>no changes</td>
<td></td>
</tr>
<tr>
<td>fewer local net systems</td>
<td></td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>15</td>
<td>13</td>
<td>3</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
<td>4</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: ECB
ECB research initiatives

- ECB-CFS research network on “Capital markets and financial integration in Europe” (http://www.eu-financial-system.org)
- 10-11 May 2004: Symposium concluding 2 years of work at the ECB in Frankfurt
Historical experiences with international currencies

• International currency: Currency that is used to a significant extent by residents of countries outside its home country
• Investment and financing, trade invoicing, price quotations, forex vehicle, forex intervention, exchange rate pegging, reserve holding
• Relationships between those functions
• For most of the times one currency clearly dominant
• But not alone, often several other international currencies, e.g. with more regional roles
• Transitions from one dominant currency to the other extremely gradual
Economic factors driving international currencies

- **Size:**
  - Network externalities in the use of money
  - The more a medium of exchange is used, the lower the cost of transacting, the more attractive it becomes for new users
  - Tends to push towards “centralisation”, a few currencies or a single one

- **Risk:**
  - A currency and assets denominated in it have a price risk (e.g. inflation risk)
  - An international investor has to diversify/hedge some of this risk
  - Tends to push for “multiplicity”, investments in many currencies

- Therefore a “hierarchy” of international currencies emerges: One often dominates but it is usually not alone
Likely scenarios for the euro

• Role of the legacy currencies, mainly the Deutsche mark
• Sizeable external use from the start
• Based on a large domestic economy, but euro area financial system still faces challenges in financial integration
• Solid anchor to price stability
• Euro should start at about the level of the Deutsche mark
• Based on its attractive size and risk characteristics its use should expand over time
• This process can be expected to be gradual
Some early evidence:

**International money market**

- In Q1 1999, money market financing in euro share more than doubled
### Share of the euro as a settlement/invoicing currency in extra euro-area exports of goods and services of selected euro area countries

*(as a % of the total)*

<table>
<thead>
<tr>
<th></th>
<th>Goods</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Belgium/Luxembourg</td>
<td>42.0</td>
<td>46.7</td>
</tr>
<tr>
<td>France</td>
<td>48.0</td>
<td>49.2</td>
</tr>
<tr>
<td>Germany</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Greece</td>
<td>...</td>
<td>23.5</td>
</tr>
<tr>
<td>Italy</td>
<td>...</td>
<td>52.7</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Portugal</td>
<td>40.1</td>
<td>43.5</td>
</tr>
<tr>
<td>Spain</td>
<td>49.0</td>
<td>52.0</td>
</tr>
</tbody>
</table>

**Sources:** national central banks and ECB calculations.

**Notes:** (...) stands for "not available". Data for 2000 and 2001 include trade settled in euro and in legacy currencies. Data refer to the use of the euro as a settlement currency, except for Germany. For Germany, data on trade in goods reflect the average value of data collected in surveys carried out in the first and third quarters of 2002 on behalf of the Deutsche Bundesbank. Data on services for Belgium, France, Italy and Luxembourg include travel, whereas travel is excluded for Greece, Portugal and Spain. Data for Italy include travel only to the extent that it is covered by data on banks' settlements.

1) Separate data for Belgium and Luxembourg were not available in 2000 and 2001.

**Source:** Review of the International Role of the Euro, December 2003, ECB
Share of the euro as a settlement/invoicing currency in extra-euro area imports of goods and services of selected euro area countries
(as a % of the total)

<table>
<thead>
<tr>
<th></th>
<th>Goods</th>
<th></th>
<th></th>
<th>Services</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>35.0</td>
<td>39.8</td>
<td>46.8</td>
<td>47.6</td>
<td>54.6</td>
<td>54.7</td>
</tr>
<tr>
<td>Belgium/Luxembourg</td>
<td>43.6</td>
<td>47.2</td>
<td>52.8</td>
<td>44.4</td>
<td>50.0</td>
<td>53.3</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>29.3</td>
<td>35.8</td>
<td></td>
<td>15.3</td>
<td>16.8</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td></td>
<td></td>
<td>40.8</td>
<td>44.2</td>
<td>49.9</td>
<td>56.1</td>
</tr>
<tr>
<td>Luxembourg</td>
<td></td>
<td>35.3</td>
<td></td>
<td>38.1</td>
<td></td>
<td></td>
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<tr>
<td>Portugal</td>
<td>47.0</td>
<td>53.6</td>
<td>57.6</td>
<td>53.7</td>
<td>55.6</td>
<td>59.2</td>
</tr>
<tr>
<td>Spain</td>
<td>44.0</td>
<td>49.7</td>
<td>55.8</td>
<td>42.4</td>
<td>45.3</td>
<td>48.7</td>
</tr>
</tbody>
</table>

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1) Separate data for Belgium and Luxembourg were not available in 2000 and 2001.

Source: Review of the International Role of the Euro, December 2003, ECB
### Share of the euro in international trade of the acceding and accession countries

(As a % of total exports/imports, in 2002)

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of exports invoiced/settled in euro</th>
<th>Share of exports invoiced/settled to the EU</th>
<th>Share of imports invoiced/settled in euro</th>
<th>Share of imports invoiced/settled from the EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>51.0</td>
<td>56.1</td>
<td>59.0</td>
<td>50.5</td>
</tr>
<tr>
<td>Cyprus</td>
<td>21.8</td>
<td>50.7</td>
<td>45.5</td>
<td>53.0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>70.4</td>
<td>68.4</td>
<td>67.7</td>
<td>60.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>70.4</td>
<td>68.0</td>
<td>61.7</td>
<td>57.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>83.1</td>
<td>75.1</td>
<td>73.1</td>
<td>56.2</td>
</tr>
<tr>
<td>Latvia</td>
<td>40.1</td>
<td>60.4</td>
<td>51.5</td>
<td>53.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>...</td>
<td>49.6</td>
<td>...</td>
<td>45.2</td>
</tr>
<tr>
<td>Malta</td>
<td>...</td>
<td>46.1</td>
<td>34.7</td>
<td>67.4</td>
</tr>
<tr>
<td>Poland</td>
<td>60.2</td>
<td>68.8</td>
<td>59.6</td>
<td>61.7</td>
</tr>
<tr>
<td>Romania</td>
<td>63.5</td>
<td>66.1</td>
<td>67.6</td>
<td>64.0</td>
</tr>
<tr>
<td>Slovakia</td>
<td>73.9</td>
<td>60.6</td>
<td>60.5</td>
<td>50.3</td>
</tr>
<tr>
<td>Slovenia</td>
<td>86.9</td>
<td>59.4</td>
<td>82.8</td>
<td>68.0</td>
</tr>
</tbody>
</table>

**Sources:** Compilation by the Secretariat of the Committee on Economic and Monetary Affairs of the European Parliament (2003), based on data provided by the statistical offices of the respective countries, with the exception of Bulgaria (for which the source is the National Bank of Bulgaria); Eurostat and IMF (DOTS).

**Notes:** ¹ January-September 2003. ² January-August 2003.

**Source:** Review of the International Role of the Euro, December 2003, ECB
Conclusions

• European financial integration:
  – has significant benefits for risk sharing, efficiency and growth
  – is progressing
  – but … is far from complete
    • progress needed (e.g. market infrastructure)
  – the ECB has an interest in fostering it

• International role of the euro:
  – the euro is already the second most important international currency
  – its role will gradually expand over time
  – the ECB is neutral about it
References


ECB (2003), Review of the International Role of the Euro, December.


