BANCO DE ESPAÑA

FINANCIAL INTEGRATION AND COMPETITIVENESS

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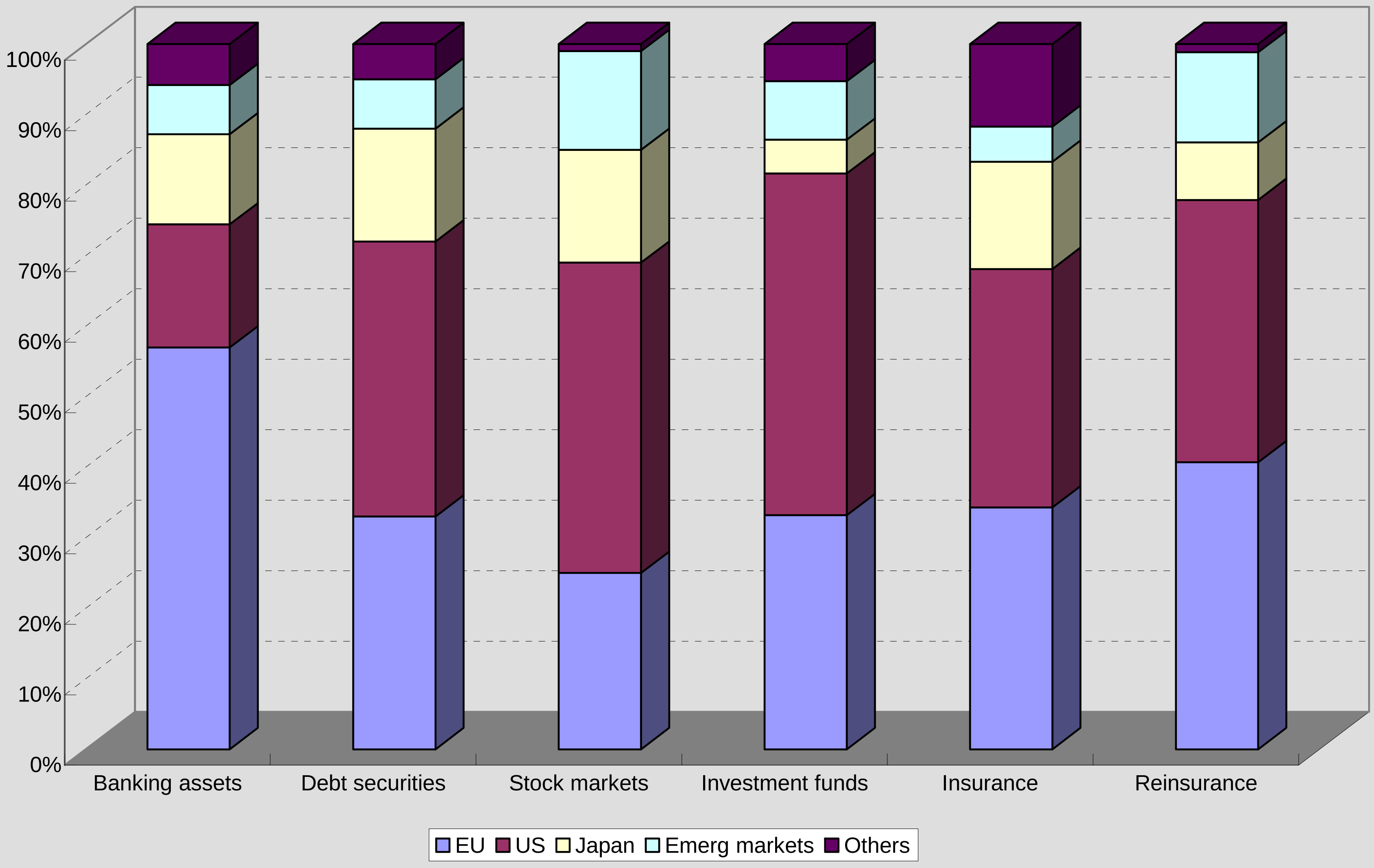
Outline

- **Importance of financial integration for competitiveness**
- **State of financial integration**
- **Role of financial regulators and supervisors**
- **Conclusions**
  - Going beyond the EU financial market

Global financial position

Chart 1: EU-15 contribution to world financial activity, (2004 data).



Competitiveness through integration

- **Single market in Europe**
  - larger markets offer higher economic benefits
  - Increase in competitiveness
- **Single financial market**
  - Spurs the development of a large, diversified and competitive financial market
  - Increase in competitiveness
    - *Improved market efficiency*
    - *Impact on investment, growth and employment*
    - *Increase in welfare*

Improved market efficiency

- **Increased competition results in a lower cost of capital for borrowers**
  - Competition widens the scope for product innovation and diversification
  - A more complete financial market
  - Improvement in risk management
- **Greater liquidity and depth of financial markets**
- **Economies of scale and scope reduce the cost of providing financial services**
- **More effective transmission of monetary policy**

Impact on the real economy

- A lower cost of capital increases the investment rate
- Higher GDP growth rate
- More employment
- Higher long-run growth potential
- More benefits for financial centers and for the least financially developed countries

Welfare effects

- **Empirical support for an increase in economic growth as a result of an improved efficiency (i.e. competitiveness) in financial services**
  - Cechini Report (1988): increase in 1.5% in GDP
  - CEPR: permanent increase in GDP growth per year around 0.2% if EU financial development were to match that of the US
  - Pooling of bond and equity markets raise the EU-wide GDP by 1.1% in 10 years

Single currency (euro)

- **The creation of the Euro is an important step forward towards economic integration and the formation of a single market in Europe**
  - eliminates national currencies
  - implies a common monetary policy
  - a unique interest rate
  - lowers transaction costs

- **Impact on the competitiveness of 12 EU countries**

Financial integration and risks

- **On the one hand, intensified cross-border financial links might increase potential contagion**
- **On the other hand, more integrated financial markets increase risk diversification opportunities, thereby boosting the economy’s shock-absorbing capacity**
- **Overall, enhanced financial integration has a long term positive impact on the stability of financial systems and of the economy**
  - Moreover, it increases resilience to shocks (as a result of enhanced risk-diversification)
  - Shocks usually have a negative and significant impact on competitiveness, at least in the short term

Financial integration in Europe

- **The Euro has been a major catalyst for the integration of the euro area financial markets**
- **However, the speed and scope of market integration has not been the same across all market segments**

1. The unsecured interbank deposit market has been almost completely integrated since the beginning of EMU in 1999, at all maturities
2. Interest rate derivatives markets also display almost complete integration
3. Among money market segments, the least integrated is the short-term securities market

    •*the commercial paper market remains segmented*

Financial integration in Europe

4. Integration in the euro area government bond market is very high

   •*no exchange rate risk*

   •*remaining differences are result of different liquidity and credit risk*

5. The corporate bond market is relatively integrated and has increased its scope to riskier issuers

6. Equity markets remain fairly fragmented

   •*country effects are still very important in explaining stock price changes*

7. Banking markets

   •*interbank or wholesale activities are fairly integrated*

   •*retail markets show a slower process of integration*

Retail banking integration in Europe

- **The view of a slower path of integration in European retail banking markets, while correct, must be qualified**
  - Lower standard deviation of interest rates for mortgages and loans to firms across European countries
  - Local banks have certain advantages vis-à-vis national and multinational banks
    - *relationship banking, proximity to customer (convenience)*
  - Profitability is not positively related to size
    - *different banks might have different strategies*
  - Significant competition within national markets can discourage foreign entry
- **While retail banking markets remain fragmented, there are certain signs of increasing integration: some cross-border M&A and internet banks**

Role of financial regulators

- **The Financial Services Action Plan (FSAP, 1999-2004) contributed significantly to the construction of a single financial market in Europe**
- **Until FSAP: new regulations were needed but the Directives were too complex and detailed**
  - rigid
  - difficult to change
  - long lags in their implementation in each EU country
  - differences in application in practice: single regulation, but 25 different interpretations
- **Conclusion: there was a need for an increase in efficiency of regulation**

Role of financial regulators

- **FSAP three main strategic objectives**
  1. To enhance a single wholesale financial market
     - *e.g. investment services directive, accounting strategy, collateral, …*
  2. To make retail financial services markets more open and secure
     - *e.g. information and transparency (mortgages), consumer protection, …*
  3. To improve the prudential framework
     - *e.g. money laundering, capital requirements for banks and investment firms, solvency of insurance companies, conglomerates, …*
- **42 initiatives, 39 adopted by EU countries as of today**
- **23 new Directives in 5 years**

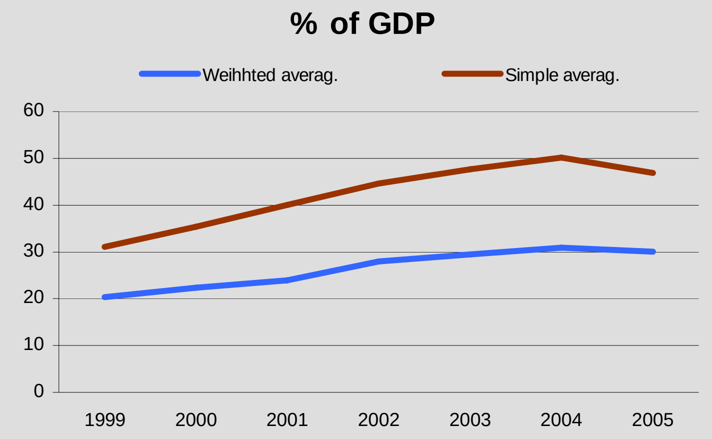
Indicators of banking integration

- **Using BIS data on total banking assets, we compute:**
  - The amount of bank assets of a given country that are owned by foreign banks, over total banking assets of the receiving country ...
    - *A measure of the degree of openness*
  - The assets held abroad by banks of a given country, relative to the total banking assets of the sending country ...
    - *A measure of internationalisation*
  - We also use to normalize the absolute flows the GDP

Openness of banking systems

Total foreign claims received from the Euro Area (% GDP)

	Received = Openness						
	1999	2000	2001	2002	2003	2004	2005
Austria	29.32	35.60	68.26	62.90	60.80	61.79	31.96
Belgium	44.27	43.73	48.93	68.73	68.01	70.39	65.85
Finland	14.51	17.84	17.12	15.65	15.12	16.82	14.09
France	14.35	16.52	16.04	17.78	18.87	20.12	19.51
Germany	11.65	10.79	10.84	16.22	17.17	18.25	17.35
Ireland	71.91	74.51	79.16	86.10	105.64	126.14	125.89
Italy	24.12	25.74	25.74	26.99	27.03	26.88	27.55
Netherlands	46.18	53.80	56.03	59.80	65.22	63.24	66.74
Portugal	37.32	55.54	58.15	66.79	71.40	67.24	66.87
Spain	17.36	19.83	20.05	25.18	27.46	30.75	32.54
Weighted average	20.34	22.35	23.94	27.93	29.47	30.91	30.05
Simple average	31.10	35.39	40.03	44.61	47.67	50.16	46.84



The amount of openness is still low

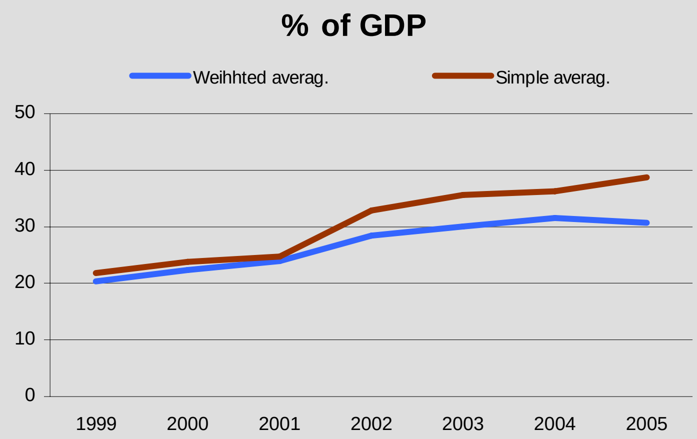
Smaller countries are more open, FR and DE the closest by far

Trend towards more open banking systems, except for 2005

Internationalization of banking systems

Total foreign claims sent to the Euro Area (% GDP)

	Sent = Internationalisation						
	1999	2000	2001	2002	2003	2004	2005
Austria	14.81	19.45	10.51	11.46	13.81	13.66	26.85
Belgium	79.12	87.32	100.64	109.87	110.98	106.65	120.34
Finland	5.82	6.60	4.26	3.98	2.85	3.17	3.53
France	21.09	18.68	18.57	23.36	23.77	26.27	25.68
Germany	22.32	27.21	32.26	31.90	33.55	35.93	30.01
Ireland	7.53	10.21	11.56				
Italy	6.72	8.27	7.81	9.20	8.12	9.19	7.91
Netherlands	33.70	33.39	34.19	73.66	86.28	92.27	92.17
Portugal	13.85	10.60	11.22	14.90	21.96	21.34	20.91
Spain	13.29	16.53	16.27	17.49	19.46	17.97	21.12
Weighted average	20.34	22.35	23.94	28.46	30.04	31.53	30.68
Simple average	21.82	23.83	24.73	32.87	35.64	36.27	38.72



The amount of internationalisation is low

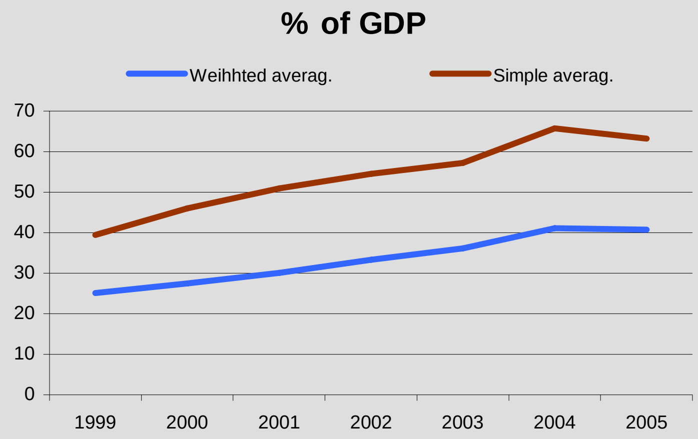
No big differences according to size, except for BE and HO

Trend towards more internalisation

Openness of banking systems

- **Total foreign claims received from Developed Countries (% GDP)**

	Received = Openness						
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Austria	38.29	45.95	79.79	74.94	72.47	74.08	43.94
Belgium	69.73	62.74	71.32	92.85	92.42	94.56	92.36
Canada	18.53	20.09	20.69	20.46	18.82	18.81	19.16
Finland	28.31	37.45	34.95	31.95	32.28	67.59	61.92
France	24.02	29.97	29.54	32.44	32.42	35.04	33.49
Germany	21.79	25.70	27.82	31.61	33.37	35.79	33.83
Ireland	110.0	122.3	133.8	142.3	175.4	208.2	213.7
Italy	31.73	35.75	35.94	38.89	37.68	36.80	36.06
Japan	8.55	7.62	8.59	8.98	10.92	12.80	10.88
Netherlands	66.45	79.44	81.25	87.43	94.39	94.27	96.59
Norway	26.89	29.75	35.96	42.79	45.59	58.40	59.40
Portugal	43.77	64.92	68.58	79.99	84.85	78.68	79.21
Spain	24.70	28.11	28.08	35.39	38.78	42.11	44.56
Denmark	30.31	42.16	49.90	54.60	56.59	90.33	90.02
Sweden	30.72	35.84	40.86	38.47	35.93	47.74	40.51
Switzerland	39.91	52.06	55.03	51.40	43.51	42.39	42.64
UK	76.75	86.26	90.17	90.20	93.85	113.0	103.5
US	20.27	22.46	24.39	27.46	30.12	33.42	35.98
Weighted averag	**25.08**	**27.50**	**30.06**	**33.37**	**36.09**	**41.14**	**40.72**
Simple averag.	**39.49**	**46.03**	**50.93**	**54.56**	**57.19**	**65.78**	**63.21**

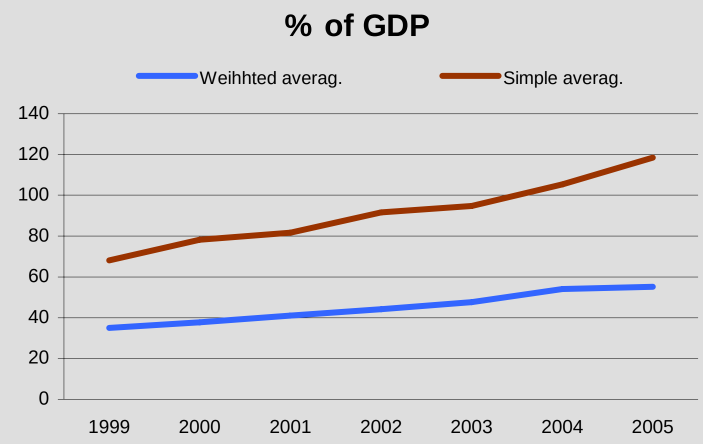


- **In general, higher level of cross border banking integration JP and CA are relatively closed, while FR and DE are close to the US.**
- **The trend towards more banking integration is confirmed among developed countries**

Internationalization of banking systems

- **Total foreign claims sent to the Developed Countries (% GDP)**

	Sent = Internationalisation						
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Austria	48.34	60.05	29.42	33.25	38.65	40.30	94.75
Belgium	153.3	175.6	199.8	223.8	218.0	218.4	242.8
Canada	44.85	42.88	48.44	45.09	42.94	39.19	41.95
Finland	24.47	29.72	42.87	41.18	35.70	39.56	37.84
France	58.14	60.37	62.01	72.83	77.59	82.51	83.64
Germany	81.95	100.0	118.6	109.9	107.2	116.5	100.0
Ireland	78.82	91.15	92.88				
Italy	21.90	26.52	25.14	26.00	22.39	23.10	20.48
Japan	22.97	24.46	28.14	28.64	28.77	32.33	36.31
Netherlands	101.5	109.3	108.1	220.4	232.1	243.1	266.0
Norway	2.20	7.96	6.68	6.86	7.75	6.84	
Portugal	39.24	39.88	36.32	36.46	46.27	51.07	49.66
Spain	42.37	63.44	59.22	52.33	48.82	69.58	75.74
Denmark	28.89	31.60	28.96	31.68	38.81	42.74	57.82
Sweden	36.04	60.90	63.95	57.17	71.88	147.1	141.8
Switzerland	372.6	401.9	432.4	478.9	495.7	532.5	526.3
UK	59.24	73.98	80.59	86.56	91.07	99.20	112.3
US	7.36	7.61	7.98	7.15	7.72	8.68	8.28
Weighted averag	**34.94**	**37.76**	**41.01**	**44.19**	**47.58**	**54.08**	**55.28**
Simple averag.	**68.01**	**78.18**	**81.75**	**91.66**	**94.79**	**105.5**	**118.5**



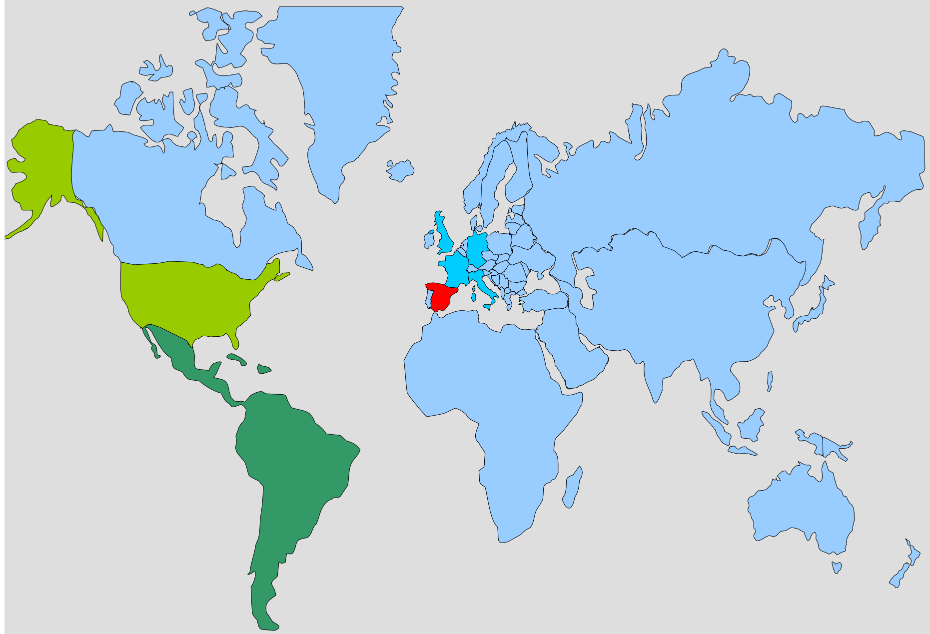
- **Higher level of internationalization (banking assets in emerging countries too)**
- **Very low level of internationalization of US banks**
- **The trend towards more banking integration is confirmed among developed countries**

Geographical analysis

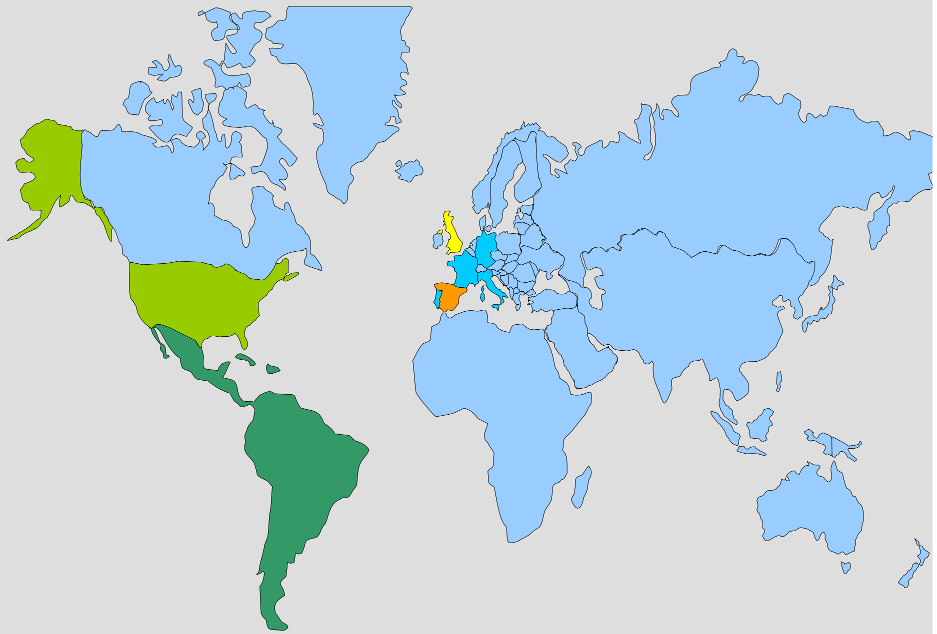
- **Integration of euro zone or EU financial markets is only part of the story**
- **The financial market is global and banking systems and large banks behave accordingly**
- **Integration happens at a world level, including the US market and emerging markets**
- **There will be always a larger presence in the original country or in large countries or where financial centers are located plus emerging markets diversification**
- **Should we talk about integration in Europe or worldwide integration?**
- **We should talk about global competitiveness and the different ways to achieve it**
  - Single large financial market
  - Openness and internationalization
  - Strong presence in the local market

Spain

1999



2005



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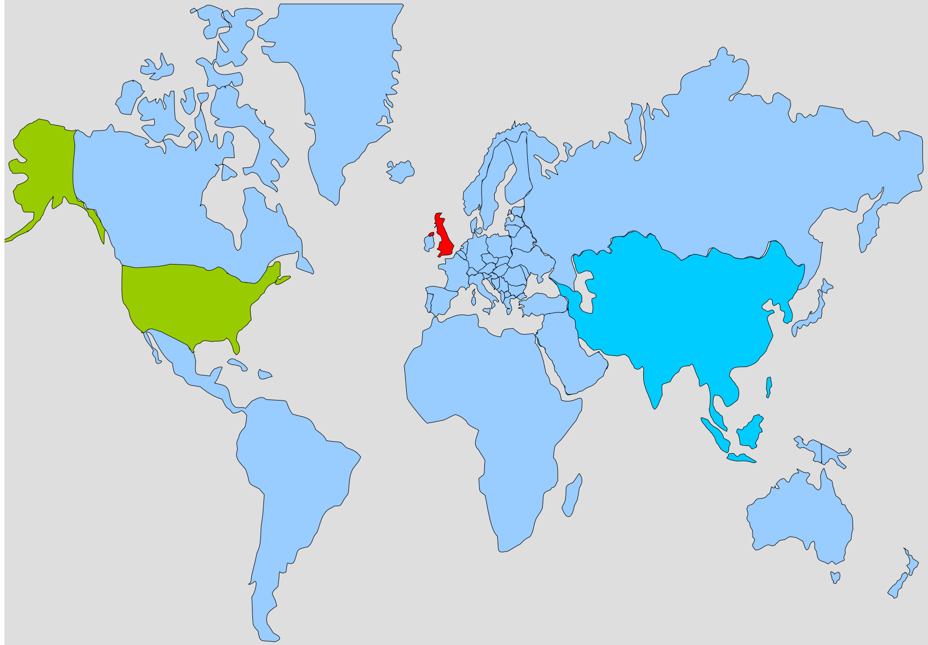
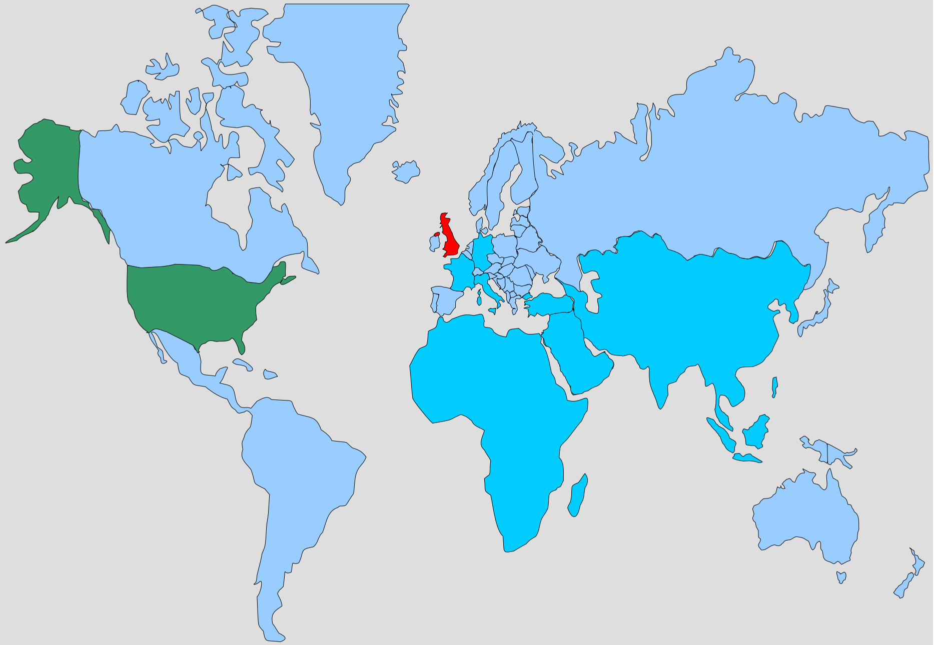
United Kingdom

1999



2005



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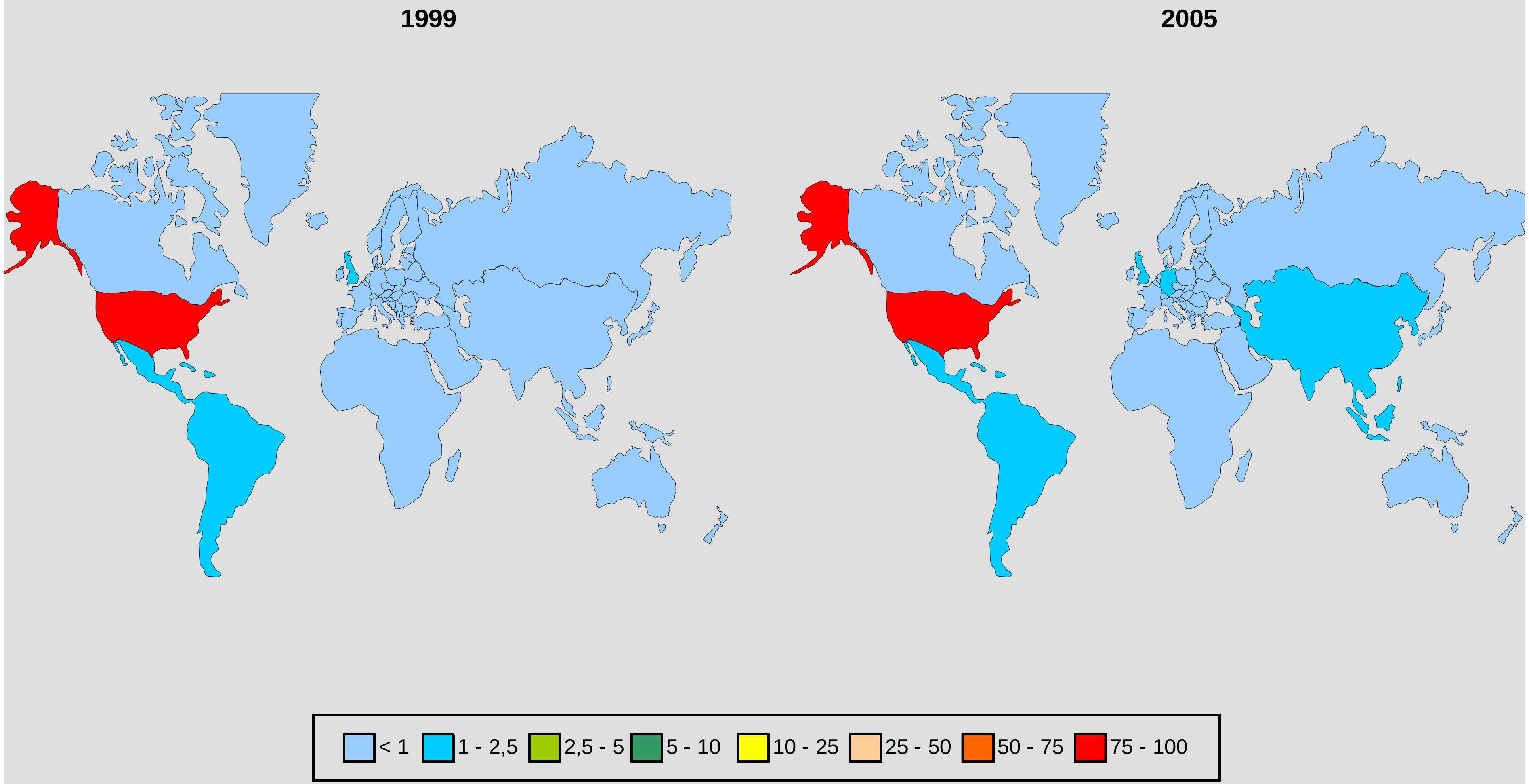
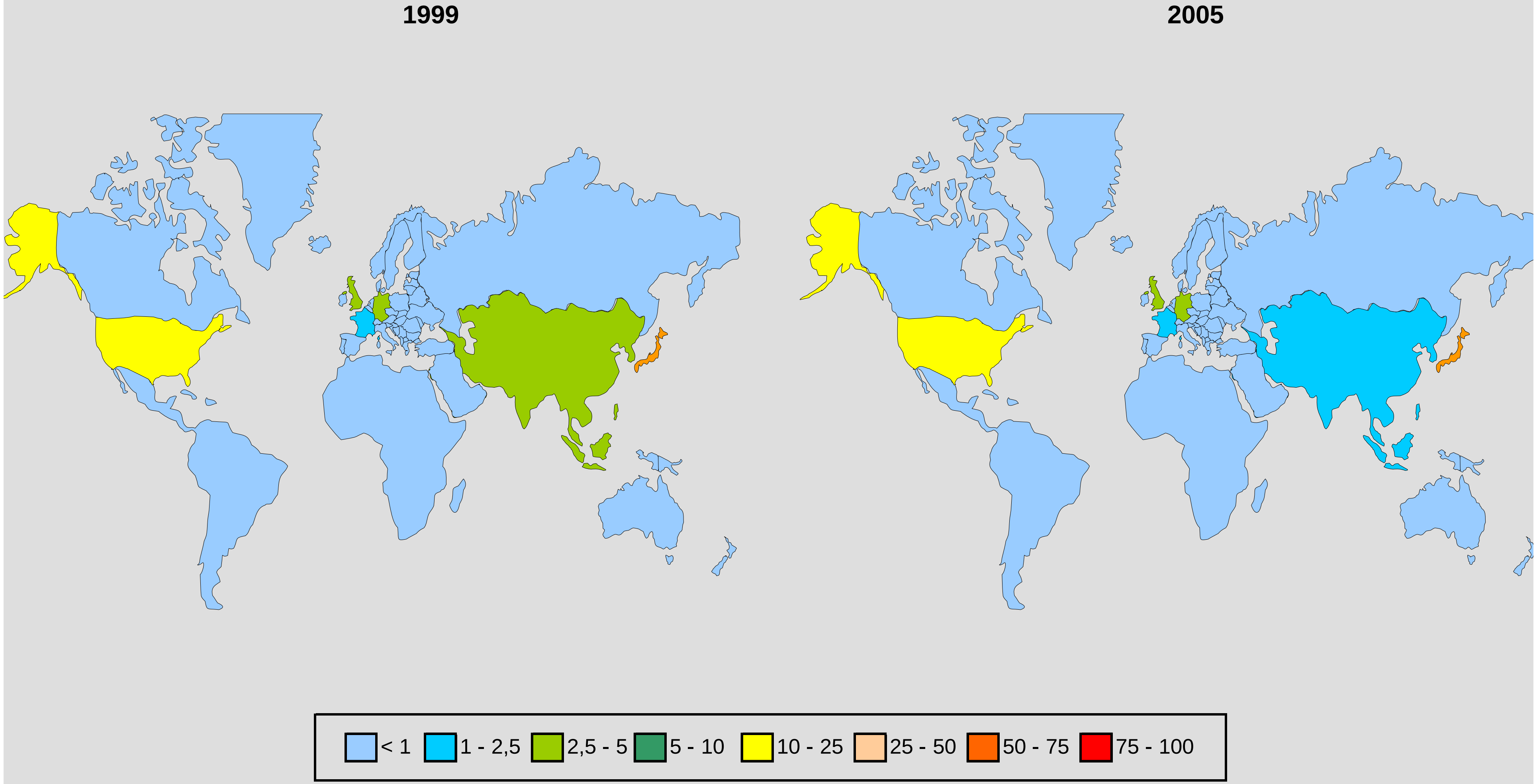
United States



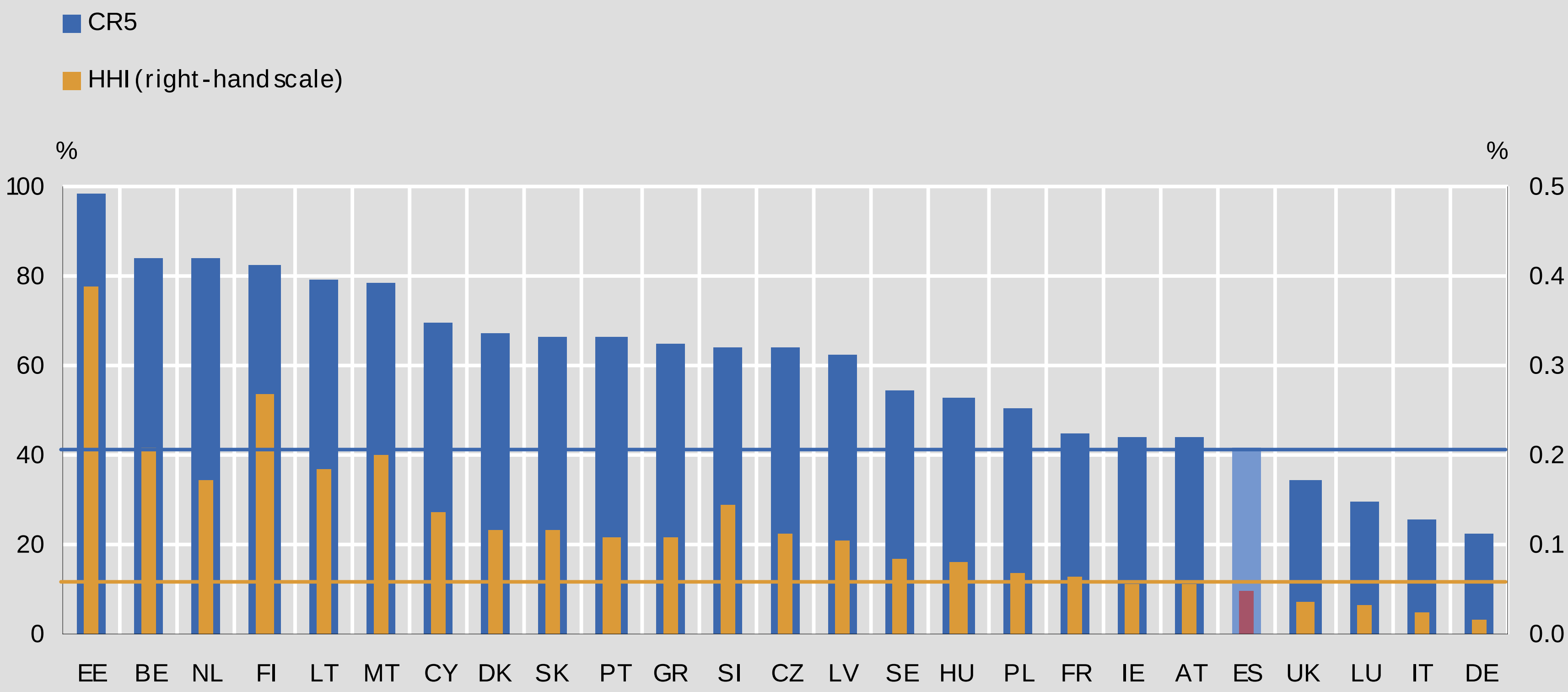
Japan



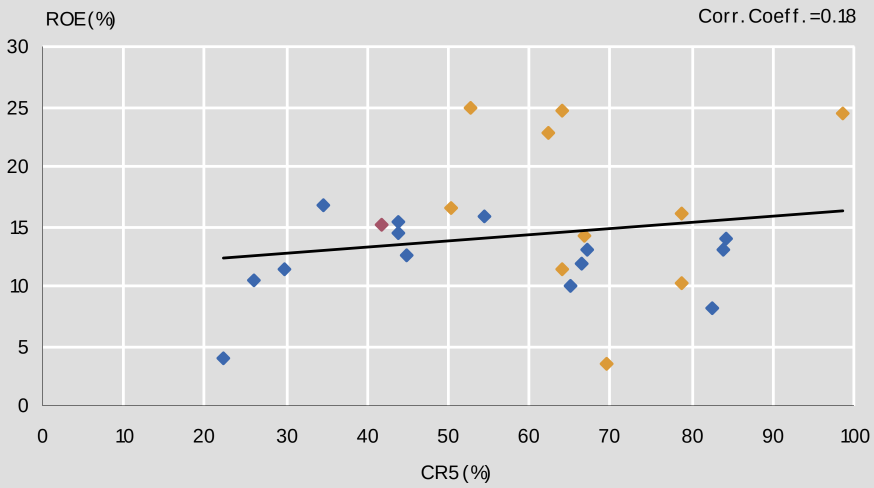
Concentration and competitiveness

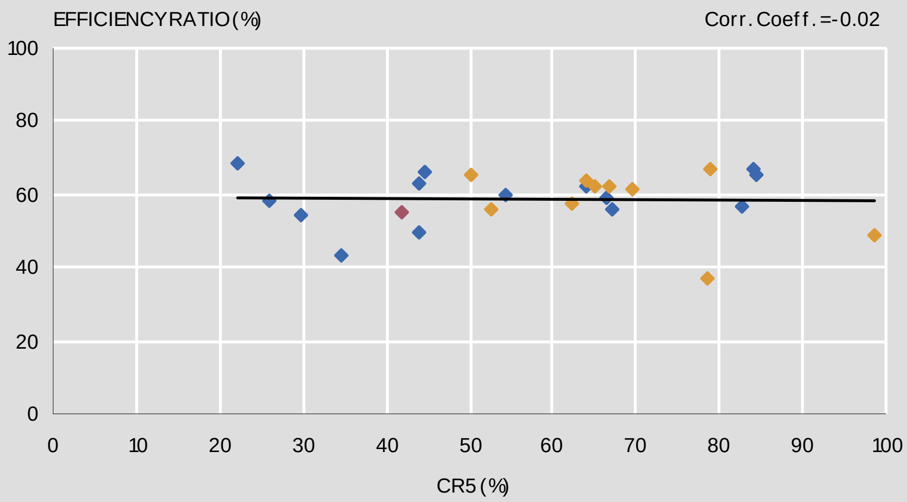
- **Relationship between concentration and competition**
  - More concentrated banking markets slightly more profitable but not more efficient
- **More competition brings about more competitiveness…**
- **…but the banking sector, given its systemic role, might be different**
  - Perfect competition might not be the ultimate target for banking regulators
  - Look for a reasonable balance between the level of banking competition and a sound and safe banking sector
  - Prudential regulation has a role to play

Concentration indexes



Concentration, profitability and efficiency

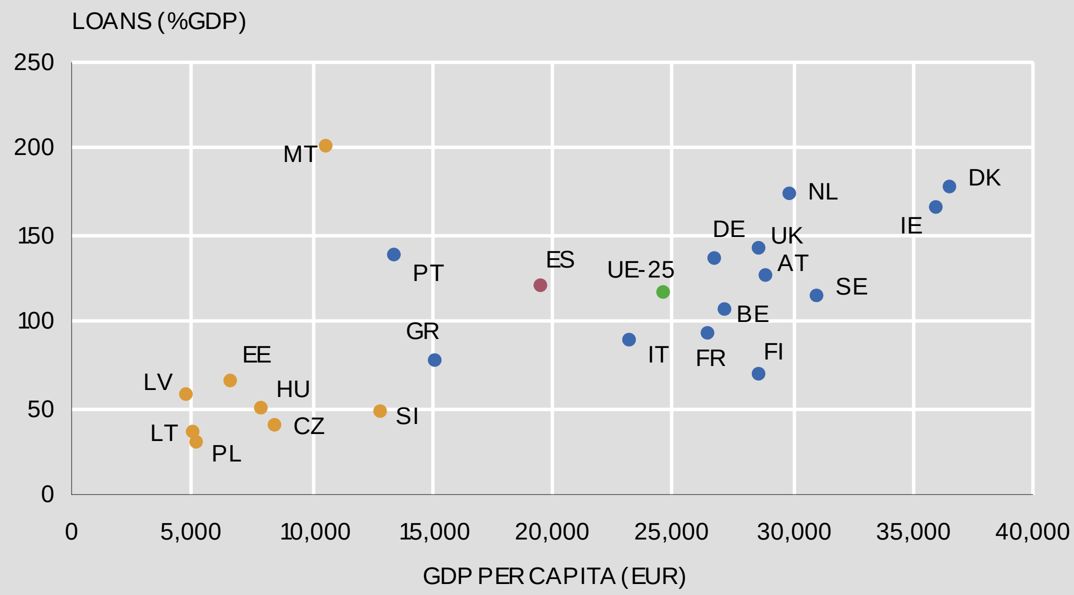


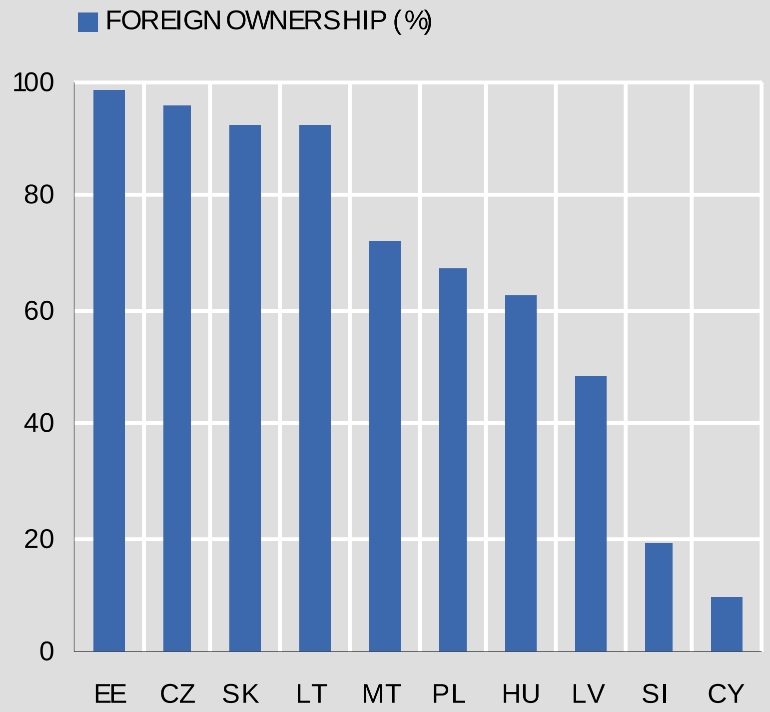


Impact on the latest entrants in the EU

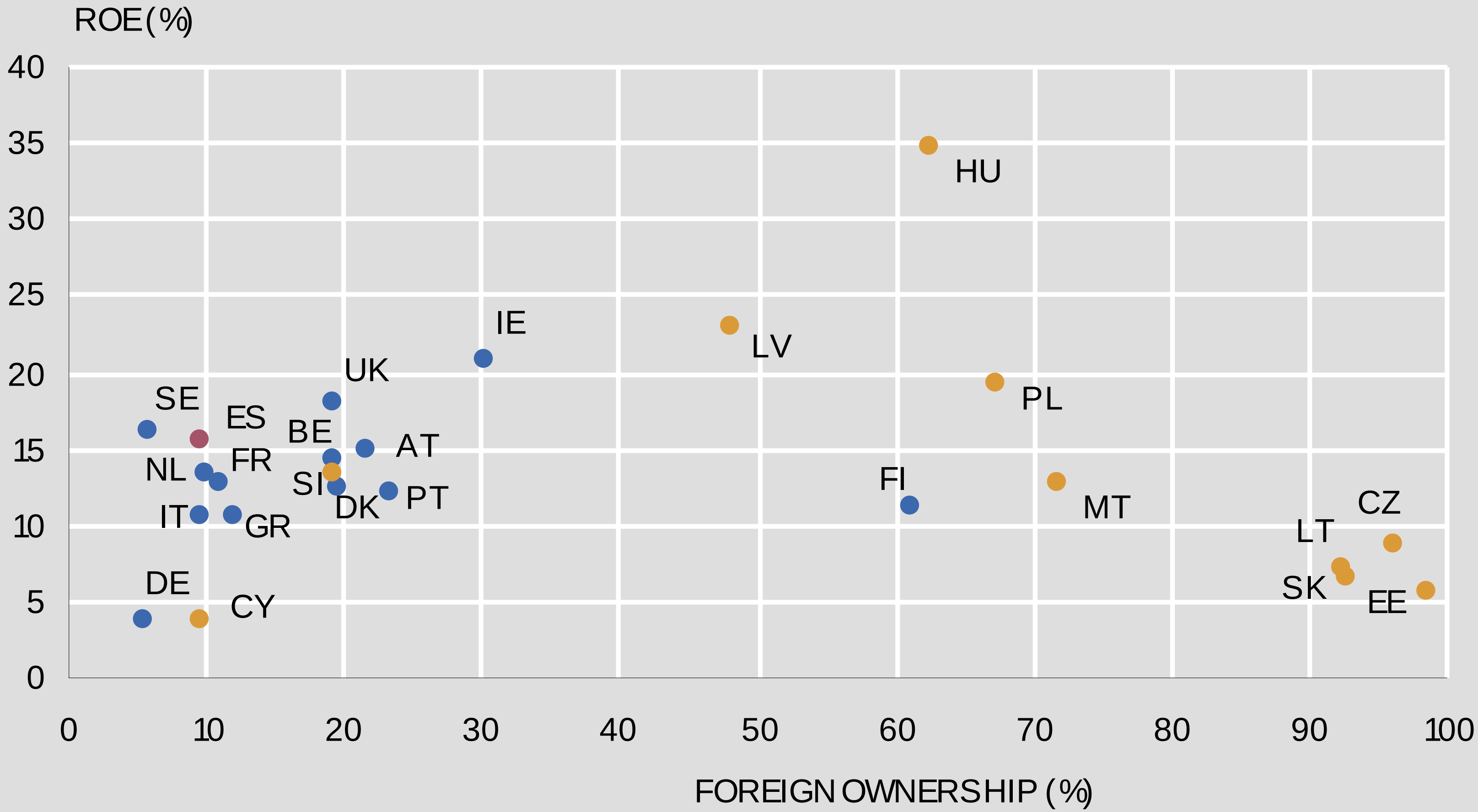
- **Lower bancarization of newer members…**
- **…but not too far away from the less bancarized EU-15 countries**
- **Very high presence of foreign banks**
  - –Historical reasons (i.e. privatizations, banking reform,…)
  - –Improvement in management
  - –Capital and know-how influxes
  - –Stronger banking systems…
  - –…part of a much more large organization
- **It seems that the higher the foreign penetration, the higher the competitiveness (proxied by ROE) for more developed banking systems….**
- **….while the opposite might happen for emerging banking systems**
  - –Data caveats

Impact on the latest entrants in the EU





Impact on the latest entrants in the EU



Conclusions

- Competitiveness is a sort of obscure word
- In Europe, competitiveness is much linked to financial integration
- Financial integration aims at reducing the cost of capital which should increase investment, GDP growth, employment and welfare
- The single currency, the euro, has enhanced financial integration in Europe, although there are some markets more integrated than others and there is still room for improvement
- Regulators have been promoting intensively financial integration (FSAP)
- Need to go beyond euro zone or EU markets
- Financial markets are global and as such are considered by the largest financial organizations
- Competitiveness needs more and more to take into account those global benchmarks

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- **Commission of the European Communities, Financial Integration Monitor, 2006**
- **Pérez, D., V. Salas and J. Saurina, "Banking integration in Europe", *Moneda y Crédito* 220, pp. 105-154, 2005 (in English)**

THANK YOU