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Europe's Monetary Union in practice

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Ladies and gentlemen,

It is a great pleasure for me to be here in Osaka. I would like to thank Osaka City University and the European Commission for organising this international symposium, and for giving me the opportunity to address such a distinguished audience.

In a speech given in October 1997, the then President of the European Monetary Institute, Wim Duisenberg, who later became the first President of the European Central Bank (ECB), forecasted that Economic and Monetary Union (EMU) would "*contribute to the creation of a large zone of monetary stability in Europe*". He continued "*the euro, in particular, will be a strong and stable currency that will foster further economic and financial integration among member countries, thereby completing the internal market*" (Duisenberg, 1997).

The expectation that EMU would promote economic stability and foster financial integration in Europe was indeed forefront in the minds of those who drafted and signed the Maastricht Treaty.

But has EMU fulfilled these expectations? This is the question I would like to answer in my intervention today. This kind of stocktaking exercise could help us not only to emphasise the achievements obtained so far, but also to identify the challenges that remain. Let me also emphasise the fact that, although Europe's experience is a unique one and cannot offer a standard solution to other regions on their road towards integration, I am convinced that an evaluation of this experience can also provide valuable lessons to other regional initiatives and, in particular, to the Asian economies.

Assessing price stability

I shall begin by assessing what can be considered the most natural goal of any monetary union: the adoption of a **credible monetary policy**. In this context, credibility should be understood as the confidence that economic agents have in the central bank to react to the various shocks affecting the economy in such a way as to be able to ensure price stability.

How can this credibility among private agents be achieved?

First, by being clearly committed to a **well-defined goal** and by pursuing it consistently and independently of political influence. Accordingly, the first two features of our monetary policy strategy in the euro area are the fact that the ECB and the national central banks (NCBs) of the Eurosystem are **fully independent**, and the fact that a quantitative definition of the ECB's primary objective – price stability – has been clearly specified. This quantitative definition (an inflation rate “below, but close to, 2%” in the medium term) provides clear guidance for inflation expectations. At the same time, it serves the purpose of accountability, since it sets a benchmark against which the ECB’s performance can be assessed.

As just noted, the ECB’s definition of price stability refers to a **medium-term horizon**, in recognition of the fact that monetary policy can control price developments only in the medium to longer term and never over immediate horizons. There are many reasons for this decision, some of them related to the presence of uncertainty in the economy and the need to anchor expectations.

The length of the lags with which monetary policy affects price developments is variable and uncertain. Moreover, the optimum monetary policy response always depends on the specific types of shock affecting the economy, as well as on their magnitude. A medium-term horizon allows central bankers the necessary flexibility to respond appropriately to economic shocks. Furthermore, a medium-term perspective helps to avoid introducing unnecessary volatility into the economy and to stabilise output and employment.

The medium-term orientation is also important from the point of view of our credibility and thus helps to anchor inflation expectations. The medium-term horizon implies accepting and communicating to the public that monetary policy cannot offset short-term changes in the inflation rate caused by economic shocks, such as sharp oil price increases or higher administered prices. It therefore also implies that short-term deviations of inflation from the definition of price stability are acceptable and do not call into question the determination and ability of the ECB to deliver price stability over the medium term.

In order to best serve its primary objective of medium-term price stability, the ECB has chosen a full-information approach which rests on **two pillars**: economic analysis and monetary analysis. This two-pillar approach therefore produces complementary pictures which can be cross-checked against each other and which together provide a comprehensive assessment of the current risks to price stability.

Furthermore, there is one feature of our monetary policy that plays a particularly crucial role in maintaining credibility and thus anchoring inflation expectations: **communication**. A central bank which does not succeed in communicating the principles underlying its monetary policy and which is perceived as acting in a non-systematic, discretionary manner will, over time, endanger its reputation.

A central bank's communication should therefore ensure that markets understand both the systematic responses of monetary policy to economic developments and the current assessment of the central bank. Successful central bank communication supports predictability and correct price formation in financial markets, contributes to the efficient allocation of funds and reduces uncertainty about future interest rates. A reasonable understanding of the monetary policy strategy among the public helps to guide price and wage-setting behaviour in a manner consistent with the objectives of the central bank.

In the case of the ECB, it was understood at an early stage that external communication would be very important. In this respect, the publication of the key elements of the monetary policy strategy in October 1998 and the communication of the details of its clarification in 2003 constituted in themselves a major step towards monetary policy transparency. In the practical implementation of our communication we make use of a wide range of channels. I will mention only two of these here:

- First, we hold a press conference after the first Governing Council meeting in each month. The introductory statement at this press conference is a key element of our communication, as it conveys the collective view of the ECB's Governing Council on the monetary policy stance in real time.

- Second, there is the ECB's Monthly Bulletin, which is published one week after the press conference. It gives a more detailed explanation of the analysis behind the monetary policy decisions, as well as regularly reporting on information collected by the ECB, such as the bank lending survey or the Survey of Professional Forecasters. Importantly, it also includes the quarterly projections, an advance copy of which is published immediately after the press conference following the Governing Council meeting. The Monthly Bulletin also contains articles providing insights into the principles governing our policy.

It is this combination of a full and transparent presentation of the monetary policy concept and strategy, a precise arithmetic definition of price stability, and detailed explanations of the ECB's assessment every month which allows market participants not only to have an intimate understanding of our policy and the way it is implemented, but also, more importantly, to correctly predict our decisions on the basis of all pertinent information and data.

The question therefore is whether the monetary policy strategy adopted since the introduction of the euro has proven to be effective in the pursuit of this goal. Looking back on the period since 1999, the answer must be a clear "yes". It is true that occasionally the inflation rate has moved above the 2% ceiling as a result of temporary shocks, for example the recent sharp rise in oil prices. In the presence of such shocks, however, what it is important from the monetary policy perspective is that price stability was maintained over the medium term, in other words, once the shock had disappeared.

Another key indicator of the ECB's monetary policy comes from expectations of inflation, which can be calculated, for example, by the differences between the returns on index-linked and nominal bonds and inflation-linked swap rates. When looking at these market prices, however, one has to bear in mind that the spread between these nominal and real yields not only measures market participants' inflation expectations, but also includes the inflation uncertainty risk premium required by investors as compensation for the risk of a loss in purchasing power. Keeping this in mind, and also looking at various measures of long-term inflation expectations in the euro area, such as Consensus Forecasts and the ECB's Survey of Professional Forecasters, one can say that long-term inflation expectations have been pretty well anchored by the ECB's quantitative definition of price stability since the introduction of the euro.

Moreover, the success of the ECB's monetary policy can also be judged through its degree of predictability, i.e. to what extent policy moves have been well anticipated by money markets. Recent studies by academics have confirmed that the ECB's level of predictability is the highest of all major central banks. Investors have indeed become more confident in their forecasts of future short-term interest rate developments prior to the ECB's monetary policy announcements. Bond market indicators paint essentially the same picture. Implied bond market volatility in the euro area is currently close to its lowest level since January 1999 (ECB, 2006).

Looking more closely at the results provided by the literature, it can be seen that, between 1 January 1999 and 12 December 2005, out of a total of 120 days on which Governing Council meetings were held, financial markets were surprised on only eight occasions. The greatest surprise was registered on 17 September 2001, when the ECB lowered interest rates at an unscheduled meeting as a response to the exceptional events of 9/11. The surprises are split more or less evenly between days when the policy rate was changed and days when it was not. All surprises on days when no changes were made to policy rates were followed by a change in policy rates a month later, suggesting that these surprises were related to the precise timing of the decisions. It is also likely that some of the surprises were related to the size of the change in policy rates. This is particularly true for surprises occurring within longer periods of gradual policy-tightening or loosening (for example, in early 2000 and early 2003 respectively). Finally, the largest surprises occurred during the first three years of EMU, indicating that the ECB's short-term predictability has increased over time. This account of events may reflect the fact that financial markets have gradually learned about the ECB's monetary policy framework and communication.

Evidence also suggests that the volatility of long-term bond futures prices increases around the time that the ECB makes its monetary policy announcements and holds its press conferences, suggesting that both of these events contain information that is relevant to bond markets. However, the increase in volatility is relatively muted and short-lived, which is consistent with the interpretation that the ECB's decisions and communication have, on the whole, been predictable.

All in all, if we consider that the ECB started without a credibility record of its own, the true magnitude of this success becomes apparent. The ECB's independence, its clearly defined mandate and its transparency in carrying out this mandate should be considered crucial underpinnings of this achievement.

Assessing financial integration

Let me now turn to the theme of financial integration in Europe. As mentioned in my introductory remarks, another important expected outcome of EMU was an acceleration in the process of European **financial market integration**. The significance of this outcome should not be underestimated. Both economic theory and empirical findings suggest that the integration and development of financial markets contribute to economic growth.

In particular, from the Eurosystem's perspective, we generally distinguish four main **benefits** arising from financial integration (ECB, 2006b):

- First, financial integration is of key importance for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area.

- Second, financial integration is highly relevant to the Eurosystem's task of contributing to safeguarding financial stability.

- Third, financial integration is fundamental both to the Eurosystem's task of promoting the smooth operation of payment systems and to its strong interest in the safe and efficient functioning of securities clearing and settlement systems.

- Finally, it is generally accepted that financial integration fosters financial development and the modernisation of the financial system and, ultimately, contributes to increasing the potential for stronger non-inflationary economic growth.

Many factors have contributed recently to enhancing financial integration in Europe, including public action at the Community level aimed at removing residual legislative and regulatory obstacles as well as allowing competitive forces to deploy their effects in full. The introduction of the euro has also played a crucial role in this respect. In particular, the elimination of exchange rate risk and the removal of barriers to cross-border trading have opened up the various markets in the euro area to many more investors.

In addition to the introduction of the euro, the ECB and the Eurosystem have played an important role in fostering European financial integration. In this respect, the ECB has defined four kinds of activity with which the ECB and the Eurosystem contribute to this process:

First, we try to enhance knowledge and **raise awareness** of the state of and need for European financial integration, and we measure the progress made – the most obvious example in this respect is the launch of our regular monitoring on the basis of quantitative indicators of financial integration in the euro area, and the numerous research activities that are being pursued by Eurosystem staff, together with academics, for example via the joint network of the ECB and the Centre for Financial Studies at Frankfurt University on "Capital Markets and Financial Integration in Europe", and in cooperation with market practitioners.

Second, we act as a **catalyst** for private sector activities by facilitating collective action and assisting with possible coordination problems. As a very recent example of this, I would like to highlight the Short-Term European Paper – or STEP – initiative, led by ACI, the Financial Markets Association and the European Banking Federation. The purpose of this initiative is to promote the further integration of the European short-term securities market via the convergence of standards and practices through market participants' compliance with the STEP Market Convention. The Eurosystem has supported this initiative since its inception. It provided technical support for the labelling process for the first two years, and the ECB produces statistics on yields and volumes in the STEP market, which it publishes on its website. These statistics are expected to play an important role in fostering the integration of the European short-term securities markets through greater market transparency.

A further example is the area of retail payments, where the degree of integration is relatively low. The banking industry has, however, launched an initiative to create a Single Euro Payments Area (SEPA), which will enable European citizens, enterprises and public authorities to make payments throughout the euro area from a single bank account, and using a single set of payment instruments, as easily and safely as in the national context today. In addition, national infrastructures will be migrated to a pan-European payments infrastructure characterised by complete interoperability between SEPA-compliant infrastructures. Sizeable financial benefits are expected from the integration of retail payments, as a result of standardisation and the opening-up of payment services markets to more competition. The Eurosystem supports this initiative and acts as a catalyst. High-level coordination takes place between the Eurosystem and the banking industry, and the ECB has arranged a number of meetings involving SEPA end-users.

An additional example of the catalyst role in the field of standard market legal documentation is the Master Agreement for Financial Transactions (known as the European Master Agreement (EMA)). The EMA is the first pan-European market standard for trading operations. It contributes to financial integration by permitting cross-border trading on the basis of a master agreement which is both a domestic and a pan-European standard. The EMA, which is a multilingual, multi-jurisdictional and multi-product master agreement, may be used to document repurchase agreements, foreign exchange, derivatives and securities loans, and generally serves to maximise cross-product netting and margining possibilities. The ECB participated in the drafting of the EMA and uses it for its relevant operations.

Third, we provide **central banking services** that also foster European financial integration. In this respect, let me mention the most prominent example: our operation of the real-time gross settlement payment system for the euro, the TARGET system. This system, which has been operational since the very first day of EMU, has supported the rapid integration of the euro money market, which is a *sine qua non* for monetary policy implementation, since only an integrated interbank market can ensure an even distribution of central bank liquidity and a homogeneous level of short-term interest rates across the euro area. The launch of the single shared platform, TARGET2, which is scheduled for November 2007, will further enhance financial integration, as it will provide a harmonised level of service and a single price structure for domestic and cross-border payments.

In July 2006 the ECB announced that the Eurosystem was evaluating opportunities to provide settlement services for securities transactions. This proposal is called TARGET2-Securities. If it materialises, it will bring about significant improvements to the way in which securities settlement in euro occurs. TARGET is the biggest payment system in Europe. TARGET2 is its second version – more efficient, less costly and more user-friendly – which is set to be launched in about one year from now. Following on from this, TARGET2-Securities is a project which would make use of (or link with) the TARGET2 platform to settle the cash legs of securities transactions.

Another example is the Eurosystem's decision to gradually introduce a single list in its collateral framework for monetary policy operations as from January 2007 with the aim of replacing the current two-tier system of eligible collateral (ECB, 2006c). The single list should enhance the level playing-field in the euro area, further promote equal treatment for counterparties and issuers, and increase the overall transparency of the collateral framework for monetary policy operations. The decision in favour of the single list in the collateral framework therefore also underlines the Eurosystem's determination to foster financial integration.

A further example of this kind of activity is the correspondent central banking model (CCBM), which exists for the cross-border transfer of collateral to the Eurosystem in addition to transfers via links between securities settlement systems. Initially, the CCBM was created as an interim model that would cease to operate as soon as the market had developed comprehensive and reliable alternatives. Today, however, it remains the main instrument for mobilising cross-border collateral in the context of the Eurosystem's monetary policy operations.

Fourth, we provide **advice** on the legislative and regulatory framework for the European financial system. Although financial integration is primarily a market-driven process, an essential task that falls exclusively to public authorities is the setting-up of an effective legislative and regulatory framework that paves the way for further financial integration by establishing basic common rules and removing obstacles to cross-border transactions.

The Eurosystem regularly contributes in numerous areas related to EU financial services policy and financial regulation. In particular, it contributed to the European Commission's public consultation regarding the priorities for financial services policies over the next five years. In that contribution, the Eurosystem expressed its broad support for the Commission's general policy orientation, such as the need to pursue supervisory convergence and the need for consolidation and consistent implementation of the existing legislative framework for financial services, which should be achieved by exploiting the potential of the existing institutional set-up, such as the Lamfalussy comitology framework. The consultation on this Green Paper led the European Commission to publish, in December 2005, its "White Paper on Financial Services Policy 2005-2010". In this document, there was a particular focus on the areas of clearing and settlement, retail banking (for instance, mortgage credit) and investment funds.

The Eurosystem also provided contributions to the Green Papers on the last two issues. Furthermore, Article 105(4) of the Treaty establishing the European Community stipulates that the ECB is to be consulted, in its fields of competence, on any proposed Community act and on any draft legislative provision proposed by national authorities.

Against this background, what is the **status of financial integration** in Europe today?

The broad finding (ECB, 2006d) is that the euro has generally acted as a major catalyst for the integration of all the financial markets. The degree of integration differs, however, between market segments and integration is more advanced in those market segments that are closer to the single monetary policy, above all the money market. Let me mention some specific results.

The unsecured euro interbank deposit market was almost perfectly integrated right at the start of 1999. The cross-country standard deviation of the average overnight lending rates among euro area countries was as low as 3 basis points in early 1999 and has since decreased to just 1 basis point. Moreover, since the launch of the EUREPO index in 2002, the euro area cross-country standard deviation of the one-month EUREPO rates has generally been below 1 basis point and that for the twelve-month maturity below 2 basis points.

The decisive role of the euro in enhancing financial market integration is also visible in the government bond markets, which shows a very high degree of integration, mainly due to the disappearance of intra-euro area exchange rate risk and the convergence of inflation expectations across countries by the time the euro was introduced. Since then, government bond yields have been driven mainly by euro area-wide factors – despite the fact that remaining differences between countries may also still be explained by differences in liquidity as well as in the availability of developed derivates markets tied to the various individual bond markets. Additionally, bond yields in different countries also reflect differences in perceived credit risk.

Our indicators for the state of integration of the euro corporate bond market are based on econometric models and suggest that this market segment is fairly integrated in the sense that the country of issuance is only of marginal importance in explaining yield differentials.

With regard to the euro area equity market, our indicators reflect a rising degree of integration. First, since the end of 2000, the advantages of sectoral diversification seem to have surpassed those of geographical diversification. Recent data suggest increased correlations of both country and sector returns. Second, equity returns in the euro area countries are increasingly determined by common factors. Third, quantitative indicators point to the fact that euro area investors have diversified their equity portfolio holdings within the euro area as a consequence of the introduction of the euro.

Finally, as regards banking markets, the indicators reveal that the euro area retail banking markets continue to be fragmented, whereas euro area interbank (or wholesale) market and capital market-related activities show solid signs of increasing integration. The finding that the degree of integration in retail banking markets is low is also supported by the comparatively low cross-border presence of euro area banks in other euro area countries. Furthermore, the cross-country dispersion of the same types of interest rates for retail banking products remains high among euro area countries and the respective cross-border banking activity is generally low. In contrast, quantity-based indicators for wholesale and capital market-related securities transactions indicate a rising share of cross-border activity. Corporate banking indicators suggest that this market segment is also fairly integrated, although further progress could still be warranted. Finally, with regard to banking market infrastructures, the situation for retail payment infrastructures is still characterised by a high level of fragmentation, which supports the general picture that the integration of retail banking markets remains limited.

Conclusion

Let me now conclude with an overall assessment. Judging from the experience to date, the euro has been an unquestionable success – euro area price stability being the best exponent. The ECB's clearly defined mandate, its independence and its full accountability are key ingredients of this success. However, this does not mean that there is room for complacency. Continued alertness is key to preserving credibility. Moreover, the performance of the euro area economy in recent years has also shown that price stability itself is not sufficient to achieve sustained growth: it is just a prerequisite, a necessary condition. Appropriate structural reforms and sound public finances are some of the most relevant aspects that are also needed to achieve sustainable non-inflationary growth in Europe.

As far as financial integration is concerned, significant progress has been made in Europe over the past few years, fostered in particular by the introduction of the euro. However, financial integration is still lagging behind in the area of retail financial services – both retail banking activities and infrastructure services for payment systems – and in the area of euro area securities clearing and settlement infrastructure. While financial integration is primarily a market-driven process, it also requires an effective interplay between market forces and the actions of the public authorities. Examples such as the STEP and SEPA initiatives show that the private sector can contribute substantially to the integration of the European financial system. The ECB and the Eurosystem welcome such market-led initiatives and will continue to support them by acting as a catalyst.

Thank you for your attention.

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