

Revised Research Priorities for the Third Phase of the ECB-CFS Research
Network on “Capital Markets and Financial Integration in Europe”

At its meeting on 14 February 2008 the Steering Committee (SC) proposed to adapt the research priorities agreed on 12 July 2006 to take account of recent developments. In particular, the network research should pay greater attention to implications for financial stability and monetary policy under the existing three priorities. This memo summarises the amended priorities. They should receive particular attention in the conferences organised during the third stage and in the Lamfalussy Fellowships granted.

1) Financial systems as risk managers, risk distributors and risk creators

A major role of modern financial systems is to allocate risk in the economy. Firms, households and governments need to undertake investments, smooth consumption or stabilise output irrespective of shocks. Well-functioning developed financial systems, involving new intermediaries, allow them to do so in increasingly flexible ways hedging risks and distributing them from agents that cannot bear them to agents that are in a position to do so. Recent financial innovations extend this function to risks that have not been tradable in the past, such as credit risk, which however remains markedly less liquid than markets for other forms of risk. As the ongoing market turmoil suggests, there can also be incentives in financial systems to create and amplify risks. Complexities and elements of intransparency in modern financial markets, including the new credit markets, may lay the ground for new forms of financial crises in which the disappearance of markets and illiquidity may play a large role. One source of complexity is the blurring of dividing lines between financial intermediaries and financial markets (including “internalisation” of trading). Research under the network should focus on the efficiency, financial stability and monetary policy implications of these developments. One important aspect seems to be which factors lead to the emergence and disappearance of new markets, including the availability of prices for valuation. How can public policy promote and support markets when they are needed? A related important aspect is liquidity, including its various micro and macro forms. For example, it needs to be better understood how monetary liquidity relates to market liquidity. Microstructure research may be

promising in contributing to the answers. When the private supply of liquidity is insufficient, can central banks still sufficiently influence the most relevant facets of liquidity? Third, which are the most important channels through which financial crises may emerge and propagate in the new financial system? Fourth, how should financial regulation and crisis management arrangements be changed to contain the new stability risks? Fifth, it is important to better understand how the new financial system affects the transmission mechanism of monetary policy (strength, completeness and relative importance of different channels) and how it works in times of instability. Sixth, the implications for consumption and investment behaviour can benefit from future research efforts.

2) Integration and development of retail financial services and the promotion of innovative firms

A variety of markets for retail financial services remain fragmented in Europe and are characterised by diverse service levels and prices as well as varying intensities of competition. Many of these markets have been subject to relatively limited research, including for example asset management, insurance, mortgages, credit cards and retail payments. An area of particular interest is the conditions under which innovative firms can receive financing and flourish more generally. This includes start-up financing and private equity business. Research could address to which extent further integration of these markets is possible. It could also analyse how – in the presence of “natural” limits to the integration of retail business – local development of and competition in these markets could be fostered and what role financial regulation and consumer protection play. Moreover, the pros and cons of smaller specialist financial institutions versus universal banks could be addressed, including in relation to financial stability. For example, leads the incorporation of retail business in universal banks to a greater resilience of the financial system? Research could also examine how venture capital markets and the emergence of innovative firms could be promoted through policy measures. What are the stability risks associated with the activities of large private equity firms? And finally, the implications of changes in retail financial markets for the transmission of monetary policy are of particular interest.

3) Financial modernisation, governance and the integration of the European financial system in global capital markets

A large body of research has highlighted the great importance of financial modernisation and development for productivity and growth. The quality of legal systems, regulations and corporate governance seem to be of key importance in this regard. But given the extreme mobility of wholesale financial services, developments in Europe cannot be regarded in isolation from developments overseas. For example, major broad governance initiatives such as international accounting standards, banking, securities or insurance regulations and Sarbanes-Oxley type of legislation can lead to major shifts of financial activity. Uncoordinated legislation and regulation can significantly increase the costs for internationally active firms, give rise to arbitrage behaviour, “export” domestic legislation to foreign countries and fundamentally change the competitiveness of a financial centre vis-à-vis others. This also raises issues about the political economy of financial markets and integration. Moreover, recent initiatives towards the creation of transatlantic stock markets illustrate the increasing connectedness of financial centres even in different time zones. Research could focus for example on which financial sector reforms would stimulate the further development and modernisation of European capital markets. It may also help explain the dominance of a small number of financial centres, why they host the most important financial innovations and how a financial centre can be promoted. In the area of financial regulation and crisis management, research could shed light on new approaches that are in line with the pace and functioning of global financial markets. Do differences in the role of investment and universal banks in different jurisdictions require different approaches?