Willem F Duisenberg: Recent developments and trends in world financial markets

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the 75th anniversary of the Banco de Mexico, Mexico, 14 November 2000.

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Introduction

I should like to thank the Bank of Mexico for inviting me to this conference commemorating the Bank's 75th anniversary.

The theme of this panel discussion is a topical one. In recent years, financial markets have undergone some of the most rapid and extensive changes in any markets. We have witnessed dramatic events in global financial markets, including the Asian crisis, the Russian crisis, and the near-collapse of Long Term Capital Management (LTCM), which was a highly leveraged hedge fund with enormous trading positions. More recently, we have seen remarkable developments in stock prices around the world, and in particular in stocks in the telecommunications and internet sectors. Many of these so-called "tech. stocks", which experienced sharp price increases in late 1999 and early 2000, have seen their market capitalisation cut substantially in recent months.

However, apart from market events such as these, global financial markets have also undergone major structural change in recent years. In particular, the speed and scope of such developments in the euro area following the introduction of the new currency have been remarkable. I should like to concentrate, today, on these structural issues, first of all considering global developments in brief, and then looking at recent developments in the euro area.

Recent trends in global financial markets

Perhaps foremost among recent changes in world financial markets has been their accelerating integration and globalisation. This development, which has been fostered by the liberalisation of markets, rapid technological progress and major advances in telecommunications, has created new investment and financing opportunities for businesses and people around the world. Easier access to global financial markets for individuals and corporations will lead to a more efficient allocation of capital, which, in turn, will promote economic growth and prosperity.

Apart from this ongoing integration and globalisation, world financial markets have also recently experienced increased securitisation. In part, this development has been spurred by the surge in mergers and acquisitions and leveraged buy-outs that has taken place in markets of late, not least in the euro area. One aspect of this securitisation process has been the increase in corporate bond issuance, which has also coincided with a diminishing supply of government bonds in many countries, particularly in the United States.

Other interesting developments in world financial markets include the continued broadening and expansion of derivatives markets. The broadening of these markets has largely come about because rapid advances in technology, financial engineering, and risk management have helped to enhance both the supply of and the demand for more complex and sophisticated derivatives products. The increased use of derivatives to adjust exposure to risk in financial markets has also contributed to the rise in the notional amounts of outstanding derivatives contracts seen in recent years, in particular in over-the-counter (OTC) derivatives markets with interest rates and equities as underlying securities. While the leveraged nature of derivative instruments poses risks to individual investors, derivatives also provide scope for a more efficient allocation of risks in the economy, which is beneficial for the functioning of financial markets, and hence enhances the conditions for economic growth.

Among the many changes in global financial markets, developments in the euro area have been particularly striking.

Recent trends in euro area financial markets

The launch of the euro on 1 January 1999 was a historic event. Eleven national currencies were converted into one single currency overnight. It marked the start of a period of profound change in Europe's financial landscape. The successful launch of the euro, which is a key element in the creation of a stable, prosperous and peaceful Europe, has also boosted the integration of financial markets in the euro area. This process of integration in European financial markets coincided with the trend towards globalisation. Both these factors help to explain current developments in Europe's financial markets.

The main catalyst behind the huge changes that have taken place, and continue to take place, has, of course, been the arrival of the single currency. In January 1999, foreign exchange and interbank markets immediately switched over to the euro. At the same time, a single monetary policy was established, with a uniform policy implementation framework for all euro area countries. Furthermore, a unified payment system was introduced, providing for real-time gross settlement transfers throughout the euro area.

As regards euro area banks, the transparency brought about by a single currency and a single monetary policy makes it easier for customers to compare bank products and costs. This, in turn, will foster competition among banks. Although this increased competition will lead to lower bank margins, it will promote restructuring and consolidation among banks in the euro area, which will help them to compete globally. In fact, these events are already happening: banks all over Europe are merging or forming alliances on an unprecedented scale, thereby drastically changing the national banking environment and creating international networks. Hence, the introduction of the euro has not only provided banks with a market large enough to support their efforts in global competition, but also pressured them to undertake the restructuring and consolidation they need in order to be successful in an increasingly global market.

In addition to these changes in the banking sector, the advent of the euro also provided the basis for a Europe-wide securities market. The euro area money market underwent a wide-ranging process of integration and standardisation following the introduction of the single monetary policy framework. The unsecured deposit markets and the derivatives markets became fully integrated in early 1999. Moreover, the need to redistribute liquidity among euro area countries, including liquidity provided by the Eurosystem as part of its refinancing operations, fostered the development of area-wide transactions in the money market. TARGET, the new area-wide payment system which constitutes the major settlement system for payments in euro, has played a key role in facilitating the redistribution of liquidity across the euro area. In addition, by encouraging greater arbitrage activity, TARGET has facilitated an equalisation of prices prevailing in the various segments of the money market throughout the euro area. While there has been less integration in other segments of the euro area money market, such as the repo markets and the short-term securities markets, I am convinced that the integration process will continue in these areas, given the favourable conditions provided by European Economic and Monetary Union.

Another sector in which impressive changes have taken place following the introduction of the euro is the euro-denominated bond market. There was a marked rise in private bond issuance in the euro area in 1999, which has continued broadly unabated in 2000. Following the introduction of the euro, the euro-denominated component of international bond markets played a far larger role than the predecessor currencies of the euro had hitherto. In other words, the whole has turned out to be much greater than the sum of the parts. Apart from this, it also became clear that various characteristics of newly issued debt securities were changing. In particular, the average size of new bond issues rose considerably in 1999, as the number of very large issues, of EUR 1 billion or more, grew significantly. These changes show that the newly created euro-denominated bond market, by virtue of its size and high degree of openness, is more able to absorb very large issues than the individual bond markets of the predecessor currencies of the euro. Hence, the introduction of the single currency has resulted in more efficient and well-functioning markets, which benefit not only euro area residents, but also market participants outside the euro area. Furthermore, this market still has great potential since the use of securities finance by the corporate sector, relative to bank finance, is still only about half that of its counterpart in the United States.

The single currency also appears to be a catalyst for restructuring the European corporate sector, and for the emergence of new companies. The ongoing integration process of the national stock exchanges has also been supportive in this respect. Primary issues of European equities have reached record highs, with whole new markets, such as the Neuer Markt in Frankfurt, becoming prominent internationally. These developments can only favour those companies which may have found it difficult in the past to finance themselves, but which will now be able to raise equity more easily. In addition, a number of Europe-wide equity indices have been established, thereby contributing to extending the trading possibilities and the position-taking opportunities for investors. Alliances between stock exchanges should also foster the integration of stock market infrastructures. These changes are bound to intensify competition and make European markets more resilient and fit for the global economy.

Conclusion

To conclude, the introduction of the euro has acted as a catalyst for promoting integration of financial markets in Europe, and provides an opportunity to create a Europe-wide securities market. The result will be more efficiently functioning markets which, in turn, will mean a reduced cost of capital and improved investment opportunities for businesses and individuals. This process will also enhance the depth and liquidity of financial markets, which in turn will promote stability.

The European Central Bank contributes to this stability by pursuing a credible and transparent monetary policy. In fact, a consistent monetary policy that is committed to price stability is the best contribution that the ECB can make to the smooth functioning and integration of European financial markets. Such a policy will be beneficial, as it will minimise the adverse effects of inflation and high inflation uncertainty, thereby creating conditions for steady and sound economic growth in the medium term. A stability-oriented monetary policy thus contributes to the smooth functioning of financial markets and to economic prosperity as a whole.