Mr Duisenberg outlines the future development of the financial sector in the euro area

Speech by Willem F Duisenberg, President of the European Central Bank, at the XXIVth IOSCO Annual Conference in Lisbon on 25 May 1999.

Introduction

The euro area constitutes a large economy, of a size comparable to that of the United States. That fact alone places the euro and the euro area financial system firmly "centre stage" in the global economy. Consequently, it is essential for the euro area financial system to be stable and efficient, not only for the benefit of the euro area economy itself, but also for the world economy.

The introduction of the euro on 1 January 1999 had a profound impact on financial systems both within and outside the euro area. Part of this impact was immediately evident in the rapid integration of money markets and the replacement of national currencies by the euro in foreign exchange markets. The fact that the changeover to the euro progressed smoothly is a reassuring indication that the euro area financial system is able to remain stable during times of structural change.

However, a further part of the impact on financial systems – most likely the greater part – will be experienced over a longer period of time. The euro is likely to become one of the major factors reshaping both the domestic financial system of the euro area and the global financial system. This process should lead to a more efficient allocation of finance within the global economy, but it will also call for the ability to adjust to structural changes in order for stable financial systems to be maintained.

Today, I should like to outline the likely future development of the financial sector and of the financial markets in the euro area as envisaged by the European Central Bank (ECB). To this end, I shall first briefly discuss the impact of the introduction of the euro on domestic money markets. I shall then turn my attention to likely developments in the financial markets and in the banking system, before concluding with some remarks on how these likely developments might affect the stability and efficiency of the financial system in the euro area.

Impact of the introduction of the euro on money markets

Until the end of 1998 the various money markets of the euro area still displayed a certain number of distinctive features. However, following the changeover to the euro they were integrated swiftly and smoothly at the beginning of January 1999.

A highly competitive single money market has already emerged in the euro area, as banks were well prepared for the changeover to the euro and the TARGET system has provided an efficient means of making cross-border payments. In particular, transaction volumes in money markets rapidly reached high levels while typical bid/ask spreads decreased almost immediately to very low levels. This indicates the depth and high degree of liquidity that the euro money market has already achieved. A feature of the current stage of the development of the euro money market, which is particularly worthy of note, is that differences in overnight interest rate spreads mainly reflect differences in the credit standing of banks rather than that of the country in which the transaction takes place.

These structural developments are, of course, positive. For the Eurosystem (i.e. the ECB and the national central banks of the 11 countries participating in the euro area) the existence of a deep and liquid money market enhances the efficiency of monetary policy operations. In this respect, I should like to draw your attention to the "market friendliness" of the framework applied by the Eurosystem to the conduct of monetary policy operations. By this I mean that the framework is based on tenders in which markets decide who receives the liquidity. The standing facilities are open and recourse to the marginal lending facility is not subject to scrutiny. In addition, the list of eligible collateral is extensive.

Prospects for the development of financial markets in the euro area

Looking now at the financial markets from a broader perspective, it is important to remember that the financial markets of the euro area began the process of integration before the start of Stage Three of Economic and Monetary Union. An indication of the pace of integration before January 1999 is provided in particular by the evolution of spreads between yields on the bonds issued by the various central governments of the euro area. These spreads narrowed continuously from mid-1995 onwards and their volatility was also noticeably reduced during this period. Factors contributing to this favourable pattern included increased convergence towards low rates of inflation across the euro area during Stage Two, the gradual reduction and finally the disappearance of exchange rate risks, the commitment of governments towards improving the sustainability of public finances, and the increase in the depth and liquidity of government bond markets.

As I have already said on a previous occasion, I believe that the interest rate markets of the euro area will increasingly provide an accurate reflection of the differences in credit quality between various issuers as well as differences in liquidity between bonds, while divergences purely related to the location of market participants within the euro area will become less and less relevant.

It seems highly likely that the capital markets of the euro area will become even deeper and more liquid over time, and hence more efficient. The number of market participants is likely to increase as the cost of financial market transactions is lowered, and the sophistication of position-taking activities is likely to increase further as market participants equip themselves with more refined methods of adjusting their portfolio exposures.

One particular area of the capital market in which the markets in euro area countries have traditionally been a lot less active than in the United States is the corporate bond and commercial paper market. However, there are good reasons to expect that corporate bond and commercial paper issuance in the euro area will gather pace in the future. During the first few months of this year we have already seen a fair amount of activity in this field.

For large companies in particular, it makes sense from the point of view of efficiency to have all the methods of financing at their disposal, namely bond and paper financing, bank loans and equity financing. Indeed, since the credit ratings of many large companies are better than the credit ratings of most banks, this should lead to savings on the cost of capital for the corporate sector. The introduction of the euro should provide sufficient depth and liquidity for the corporate debt market that would guarantee competitive pricing.

On the demand side, the reduced borrowing of the public sector will leave more room for the private sector to issue debt securities. As you know, the amount of public debt in the euro area is still high, and we trust that governments will keep their commitment to bring it down to more sustainable levels as agreed in the Stability and Growth Pact. In addition, the euro area has to save in order to be able to take care of its future pension payments, and a part of these savings is likely to be invested in corporate debt securities. An increase in global demand for euro-denominated debt securities is also expected as the euro becomes a major reserve currency. Moreover, the demand for higher-risk euro-denominated debt securities is likely to increase, particularly as the current low level of sovereign yields increases incentives to search for higher yields.

Turning to equity markets, and first to the institutional set-up of stock exchanges, an evolution towards more integration and greater market efficiency is already apparent. As consolidation within the financial services sector has increased the size and geographical reach of intermediaries and fund management institutions, they seem to be pressing for market-places to become more concentrated in order both to reduce costs and to enhance liquidity. In addition, some companies have recently announced that they are reviewing their listing practices with the aim of reducing costs by cutting back on the number of exchanges in which they are listed.

However, this development towards greater concentration does not necessarily mean that trading is concentrated only in a few exchanges. A possible pattern of development could also be for different stock exchanges to concentrate on specific types of companies (“blue-chips”, specialised industries, small companies and new companies, for example). In any case, the physical location of stock exchanges is becoming less relevant as screen-based trading with remote access is becoming more widely used.

With regard to investor behaviour, an increasing number of equity market investors already appear to be taking positions on the equity market of the euro area from a sectoral rather than a national perspective. Area-wide equity indices have been made available by various market participants, thus providing investors with opportunities to monitor area-wide equity positions as well as, in some instances, positions in area-wide industrial sectors.

The fact that the euro area (and EU) equity markets are becoming more integrated, more liquid and deeper is good for market efficiency, and a more efficient allocation of capital should mean that equity financing becomes more readily available for companies.

I should also like to mention that a prudent, harmonised regulatory framework, on the one hand, and harmonised market practices, on the other, are key factors guaranteeing a favourable outcome for these structural changes. In these areas a lot of work is under way, and much has still to be achieved in order to pave the way for truly integrated financial markets. Harmonisation in, for example, repurchase agreements, national company laws including bankruptcy laws, and other aspects of the legal and regulatory framework, would enhance legal clarity and certainty and thereby improve the efficiency and stability of the financial markets.

Indeed, the European Commission recently published an Action Plan containing priorities and timetables for measures aimed at improving the single market for financial services. In the Action Plan, measures are proposed to advance the harmonisation of the legal framework and market information, as well as to facilitate investors’ operations throughout the single market.

In this respect, I should also like to pay tribute to the International Organization of Securities Commissions (IOSCO) for its efforts. Although I have focused mainly on the financial system of the euro area, we can clearly see that the euro area financial system is an integral part of the global financial system. With this in mind, I should like to express my support for the aims of IOSCO to promote high standards of regulation in order to maintain just, efficient and sound markets.

Prospects for the development of banking systems in the euro area

Turning now to likely developments in the banking system, it is important to note that the euro area financial systems in general and the banking sector in particular have, until now, been relatively national and fragmented with little cross-border retail activity. However, it is envisaged that the euro will add weight to a number of fundamental factors that are increasing the pressure for structural change. With these structural changes I mean not only consolidation, which seems inevitable, but also increased cross-border co-operation and mergers. In short, the euro area banking sector is expected in the future to look and behave more like the banking sector of a single economy.

In addition to and reinforced by the introduction of the euro, other factors that are leading to changes in the financial landscape include technological development, globalisation and changes in what consumers and firms expect from the financial system and financial service providers. These factors are reshaping the business of banking as well as the financial system as a whole. Economies of scale and scope may have been changing in different areas of banking and even taking different directions. For example, the rapid development of information technology has made the collection and processing of information considerably cheaper, but at the same time technological investments are taking a larger share of banks' resources. Therefore, economies of scale in some aspects of the collection of information may have been reduced, but at the same the time investments in more sophisticated technology have increased economies of scale and scope in some areas of banking. While I do not wish to go into detail on this matter, the general picture that emerges is that the banking industry has to be in a position to adjust to a new situation and take these factors into consideration.

Indeed, in the course of the last few months, a number of bank mergers in the euro area, including mergers between relatively large institutions, have been announced or are being contemplated. Such "high-profile" mergers are likely to contribute to an acceleration of the pace of both the consolidation and integration of the banking systems of the euro area.

However, it should be remembered that the recent pattern of consolidation represents part of a longer-term trend in the European banking industry, as is highlighted by the large decline in the number of credit institutions in the euro area countries over the past decade or so. In the mid-1980s there were more than 11,000 credit institutions in the euro area countries; today they number around 8,000. This sharp decline in the number of credit institutions is mainly the result of mergers among savings and co-operative banks, which epitomise what one may call "consolidating" or "defensive" mergers – mainly aimed at cutting costs and diversifying risks but also at reaching a size of own funds compatible with a regulation that has been agreed at the EU level.

So far, this consolidation process has taken place mainly within national boundaries, with the possible exception of the Benelux and Nordic countries. The preference for domestic mergers (as opposed to cross-border mergers) may be explained by the fact that the relevant market for retail services remains national rather than pan-European. Furthermore, the scope for cost-cutting appears to be larger if the merging institutions have overlapping operations. The fact that cultural "proximity", notably in the corporate style of governance and management, is traditionally seen as a key factor in the success of mergers may also have played a role. However, from my own professional experience of running a truly pan-European bank, I could add that professional identity is a much stronger force for unity than national identity is a force for separation.

Conclusion

I have outlined the likely pattern of evolution that we envisage for the euro area financial system. Summing up the various elements, we see a pattern which leads towards a financial system that should perform its functions more efficiently using the advantages available to the financial system of a large economy. A large financial system can be more readily versatile, i.e. provide investors and those in need of financing with a full range of options to choose from according to their requirements.

What does all of this mean for financial stability in the euro area?

First of all, I should like to remind you that the financial system of the euro area showed a high degree of stability during last year's period of financial turbulence as well as during the rather dramatic structural shift connected to the changeover to the euro. In the former case, it is true that there was a significant spillover effect for the euro area markets, but they recovered quickly and without suffering any lasting damage. There was no disruption to any of the basic functions of the financial system, and public confidence in it remained strong throughout.

Second, the foreseen structural changes require, as I mentioned earlier, the need for adjustment to be taken seriously by all participants in the financial system. This adjustment appears to have intensified recently: there has been an increase in merger activity, an establishment of alliances and an introduction of new products and services, often based on modern information technology. The process of structural change contains risks, but if these risks are identified early and analysed carefully, they do not present a threat to financial stability. After all, we are talking about decision-making and planning by people who are dealing with risks every day at the highest professional level. In this regard, the smooth changeover of the financial system to the euro demonstrates the virtues of efficient and careful forward planning.

Third, I do not view efficiency and stability of the financial system as being contradictory. In many ways these qualities actually support each other by laying a firm foundation for the financial system. An inefficient financial system, in addition to being costly to society, can be more vulnerable to shocks.

At the ECB, we play our part in the evolution of the euro area financial system by providing it with stable monetary conditions. By creating an environment of price stability, we allow private sector agents to focus their attention on the questions that are most relevant to their activities and to take advantage of the benefits of this stable environment, such as the lengthening of their planning horizons.