Mr Duisenberg reports on developments in the financial sector in Europe following the introduction of the euro

Speech by Dr Willem F Duisenberg, President of the European Central Bank, delivered at the Third European Financial Markets Convention in Milan on 3 June 1999.

1. Introduction

The period of the five months following the introduction of the euro has been very rich in new events, with significant developments taking place both in the continental securities markets and in the financial system as a whole. Although experience has been gathered over a relatively short period of time, I am tempted to make two observations of a fundamental nature.

The first observation is that developments following the introduction of the euro do not imply that the euro area is set to become a financial fortress whose financial markets and institutions would be cut off from the rest of the world. In fact, market participants residing outside the euro area seem to be taking a keen interest in the financial markets of the euro area. “Core Europe”, so to speak, has become more interesting to outsiders as the breadth and liquidity of its financial markets have increased.

The second observation is that the euro can be expected to have a significant influence on the structure of the financial system by bringing about more securitisation. A traditional feature of the financial system of continental Europe has been a marked dependency on the funds intermediated by banks. This feature contrasts with the financial system of the United States, which is much more securitised. For instance, corporate bonds have not been very widely issued in the euro area, and stock market capitalisation – relative to the size of the economy – is much lower in the euro area than in the United States. There are good reasons to believe that a process of securitisation will gather pace in the euro area now that the single currency is in use. This view seems to be shared by many observers and I shall, in the course of my remarks, provide some arguments in its favour.

In my remarks today, I should like to discuss the structural changes in the financial sector, in particular those that have occurred as a result of the launch of new product types and the changing nature of public and private institutions. I shall address developments in the money markets, the bond markets and the equity markets as well as the process of adaptation of banking institutions to their new environment.

2. Money markets

The money markets of the euro area became rapidly integrated after the introduction of the euro despite the fact that their structures had previously been quite different at the national level. Transaction volumes and measures of bid-ask spreads on the various money market instruments both indicate that the markets reached a very high level of liquidity very rapidly in the course of January 1999 and have subsequently retained it.

The high degree of integration of the euro area money markets is, first of all, a result of the single monetary policy, which is conducted through the harmonised operational framework of the Eurosystem. This integration has also been made possible by the significant and increasing integration of payment systems. Cross-border payments processed by TARGET accounted for more than 37% of the value of all real-time payments (domestic and cross-border) effected by credit institutions in March and April 1999. Moreover, the continuously high use which our counterparties make of the correspondent central banking model (or CCBM) for the cross-border transfer of collateral in monetary policy operations is an important indication of area-wide integration. This is evidenced by the fact that cross-border collateral currently represents around 25% of the total amount of collateral in custody in the context of the Êurosystem’s monetary policy operations.

Taking a closer look at the various instruments traded in the money markets, a feature that is worthy of note is that market participants in the 11 countries of the euro area have shown an increasing tendency to demonstrate a similar reliance on each instrument type. For example, what we call "overnight indexed swaps", which are swaps indexed on the overnight reference interest rate EONIA, have become an important derivative instrument in the money markets of the euro area. This can be seen from the low level of quoted bid-ask spreads and the high turnover relative to other major international markets. Both indicators show a high level of liquidity in this instrument. Another type of instrument of interest in the money market (but also at the fringe of the bond market) is that of the repurchase agreement. The development of more integrated repo markets in the euro area will obviously accompany the development of area-wide securities trading, settlement and custody systems. This will reduce transaction costs and improve efficiency for the cross-border transfer of securities through repurchase operations.

Looking ahead, other developments in the money markets are expected in the coming months. There are aims to establish new area-wide standards for the repo markets, with a view to overcoming the separation between different models in the national markets. These new standards could obviously co-exist with other standards and broader conventions for international transactions. In fact, over the last few months the European Central Bank (ECB) has been examining whether this co-existence could affect the integration of money markets. We have come to the conclusion that, in particular owing to the efforts of the sponsors of the different standards, this should not be considered a threat.

Finally, it should also be noted that national and international central securities depositories are currently developing links with one another, which will enable participants in one country to make direct use of securities deposited in other countries. Twenty-six of these links (concerning mainly Belgium, Germany, France, Luxembourg, the Netherlands, Austria and Finland) may be used by the Eurosystem.

3. Bond markets

I should now like to turn to bond markets and first to comment on the position of euro area bond markets in the global market. Some data sources on international securities issuance available so far show a pattern of increased reliance on euro-denominated bonds at the beginning of 1999, in particular as opposed to US dollar-denominated bonds. While it remains difficult to draw firm conclusions on the determinants of bond denomination choices without considering information on the nature of bond holdings and trading patterns, recent bond issuance volumes indicate that the euro has the potential to become an important currency for international bond issuance.

The importance of the euro area bond market is also apparent in measures of secondary market activity, i.e. turnover or trading volumes. In particular, trading volumes on exchange-traded bond futures are indicative of the overall degree of market activity. Volumes traded in euro-denominated bond futures were low shortly before the changeover to the euro, when the bond markets in the euro area were exceptionally quiet. Since then, volumes have increased markedly and they currently stand at consistently high levels, which indicates a continuously high degree of turnover in euro-denominated bond markets in general.

Turning to the internal structure of the bond markets of the euro area, I should like to make an initial observation related to the recent marked increase in euro-denominated corporate bond issuance, which was accompanied by an increase in the average size of issues. This tendency is likely to continue in the future, in particular to the extent that bonds may be used by firms to finance increasing mergers and acquisitions activity in the euro area. The underlying reasons for increased bond issuance by euro area firms are clear, both on the supply and on the demand side. On the supply side, large firms with good credit ratings will find opportunities in the increased depth and liquidity of the euro area bond market. On the demand side, the respect by governments of the parameters of the Stability and Growth Pact over the medium term should leave more room for the private sector to issue debt securities. In addition, the euro area must be in a position 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.

With regard to the government bond markets, an issue of importance for the euro area that I should like to stress is the fact that governments now find themselves in a rather new position as issuers. This reflects a number of developments, two of which I should particularly like to mention. First, the major public issuers have attempted to position themselves as providers of benchmarks for euro-denominated bond markets. Second, certain issues of government bonds have effectively gained larger portions of secondary markets, in particular in relation to developments that have occurred on bond futures markets.

Market participants have responded to these developments in the bond markets with a range of concurring or competing initiatives and alliances. In the derivatives industry, market participants have established new alliances. On the trading side, electronic cross-border platforms for bonds have been created or are in the process of being developed. On the clearing side, integrated platforms for different markets have been launched or are being finalised, while, finally, on the securities settlement side, initiatives have also been launched. It is important to note that while some of these developments are internal to the euro area, others aim at creating links with financial markets outside the euro area. One may reasonably expect that all of these new circuits, as well as others, may in the future be enlarged to encompass a growing number of market participants.

4. Equity markets

Turning to equity markets, structural developments of most interest relate to the infrastructure of stock exchanges on the one hand and equity derivative exchanges on the other. First, within the euro area, equity investment and trading activities appear to be less and less influenced by country-specific factors and increasingly subject to area-wide considerations. Consistent with this development, area-wide equity indices have been developing. Market participants are showing considerable interest in these area-wide indices, in particular as they are also now adopting investment positions on area-wide industrial sectors, using the sub-indices made available for that purpose. An indication of the degree of interest raised by area-wide indices is the relatively fierce competition for benchmark status that has developed between the various proponents of area-wide indices.

Second, market developments in relation to stock index futures and options will reflect the rise of area-wide indices. This may in turn lead to either consolidation or product specialisation of equity derivative exchanges. For my part, I consider the development of fair competition between exchanges to be a positive factor in terms of the improvement of the range of products and services available to the financial industry.

Third, in the equity market the euro has also provided a powerful incentive for the creation of new – and possibly competing – alliances among exchanges. Before the launch of the single currency, circuits had been created for the launch of integrated “new markets” within and beyond the euro area, encompassing the shares of small and medium-sized companies with a high potential for growth. The development in the integration of exchanges has also continued more recently, and, as you know, it has not been limited to the euro area.

5. Banking

In the field of banking, the securitisation trend appears to demand strategic and organisational adjustment on the part of banks. The relative importance of the more traditional types of banking activity can be seen to be decreasing, even though it should be mentioned that traditional banking activities have nonetheless continued to grow at a rate exceeding that of growth of nominal GDP. In the euro area, growth in recent years has been much more rapid in assets under the management of mutual funds and other institutional investors than in the assets of banks. This reflects a tendency towards decreasing the relative weight of bank deposits compared with securities in financial wealth.

The euro area banking industry has reacted to this development already by diversifying into the asset management area. Banking groups have been able to "internalise" a significant part of the securitisation tendency as they control a large majority of the mutual funds. As a result of the securitisation trend, there has been an increase in the share of security holdings among bank assets, and an increase in the share of capital gains – although those are quite cyclically sensitive – as well as in fee income stemming from asset management services. Meanwhile, the relative importance of interest income has declined correspondingly. At the bank level, dividend income from equity participations has generally become much more important, indicating an increase in the importance of the profit generated by non-bank subsidiaries.

Beside the establishment of non-bank subsidiaries, there have been other strategic and organisational changes that have resulted in banks strengthening their securities-related activities. In particular, significant motives behind the recent merger trend seem to include the desire to increase bank size and hence to be able to operate efficiently in wholesale securities markets as well as to be able to cater for the needs of large international corporations for investment banking services.

The trend towards securitisation can be regarded as one of the reasons for the structural changes in the banking system that appears to have accelerated recently. There have naturally also been other reasons why banks have sought to merge, predominantly the need to cut capacity and to reduce costs. These cost-driven mergers have taken place primarily among smaller banks.

6. Conclusion

In my remarks today, I have referred to a number of changes and market initiatives in the euro area financial landscape. These developments point to the increasing importance of the fixed income and equity markets that many expected in Stage Three of Economic and Monetary Union (EMU), providing new opportunities for borrowers and investors and causing pressure to adjust for financial institutions. In this respect, I should like to mention the importance of removing the remaining regulatory barriers to the further development of the securities markets. To this end, the European Commission has recently published an Action Plan of regulatory changes to improve the single market for financial services that would certainly – when implemented – boost the integration and market-driven development of the European securities markets.

Finally, I should like to conclude with some remarks about the role of the Eurosystem (the term that we use to mean the ECB and the 11 national central banks of the Member States participating in Stage Three of EMU) in the developments in the financial sector in Europe. First of all, the Eurosystem contributes to developments in the financial sector by providing it with a stable and credible monetary policy. With a strong and credible commitment to its primary objective, price stability, the Eurosystem has created a situation in which the financial sector can concentrate on those issues that are of the greatest relevance to its activities.

The Eurosystem does not play a direct role in structural developments in the financial sector. With its single monetary policy framework and TARGET in particular, the Eurosystem has created an infrastructure that has proved to be useful for the establishment of an integrated money market in the euro area.

In addition, the Eurosystem carefully monitors structural developments in the financial sector to the extent that they might have an impact on the conduct of monetary policy. To make a final point, in observing developments in the financial sector, the Eurosystem constantly takes account of the fact that one of its tasks, laid down in the Treaty establishing the European Community, is to "contribute to the smooth conduct of policies pursued by the competent authorities relating to (…) the stability of the financial system" [*(Article 105 (5))]*. Analysis of the common developments in the European financial system represents such a contribution.