Mr Haferkamp focuses on European capital markets in the first year of EMU

Keynote address given by Mr Dieter Haferkamp, Member of the Directorate of the Deutsche Bundesbank, at the conference on “The Pfandbrief: Global Perspectives for Europe’s Biggest Bond Market” in London on 28 September 1999.

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1. I am delighted to have been given this opportunity to speak at this now almost traditional Pfandbrief conference. Keynote speakers at a Euromoney conference have the privilege of choosing their own topic. I am not a “Pfandbrief” specialist. As a representative of the central bank of a country participating in monetary union, I feel more at home making some comments on the monetary and capital market policy environment, which is likely to have a major impact on the development of the European bond markets and thus also on the fate of the Pfandbrief.

In many ways, the liberalisation of investment services in the European Economic Area, the creation of electronic markets and the internationalisation of financial portfolios did away with the segmentation of Europe’s capital markets even in the years prior to monetary union.

But then, overnight, the start of European monetary union brought about major structural changes which forced all the market participants to undergo the appropriate processes of adjustment. This applies also, and especially, to the market for Pfandbriefe.

The German Pfandbrief goes back more than 200 years. However, only during the past few years have the international capital markets discovered it. The Pfandbrief’s success story is attributable to two factors. The Pfandbrief has an excellent credit quality, and it firmly embodies the principle of investor protection. Admittedly, neither of these advantages would have sufficed by themselves for the Pfandbrief to hold its own in intensified European and global competition. It was only the efforts made by German mortgage banks to market these bonds internationally which enabled this traditional German product to achieve a breakthrough in the markets.

The most important milestone in these efforts was undoubtedly the introduction of Jumbo bonds in May 1995. With the characteristics of the Jumbos the Pfandbrief was also equipped with the liquidity which globally operating investors expect of today’s capital market instruments. And allow me, as a representative of the German central bank, to add that the stability of the D-Mark, which was the most important currency of issue for Pfandbriefe up to the introduction of the euro, contributed more and more to attracting international investors to the Pfandbrief product.

Like German government bonds up to the end of last year, the Pfandbrief, too, enjoyed the competitive advantage of having a strong domestic currency. Now, nine months after the start of monetary union, it can be stated that both products, Pfandbriefe and German Federal bonds, have successfully made the transition to the age of the euro. Even without the seal of quality of the D-Mark as the issuing currency, the German Pfandbrief was not only able to maintain its position but also to continuously improve it. Thanks to a thoroughgoing and consistent process of modernisation, it has become an international brand-name product which has prompted issuers in other countries to consider introducing similar products. Spain and France are two current examples here.

I would now like to comment on two questions:

- What were the most important changes in the Pfandbrief environment caused by the introduction of the euro? What is the shape of the “new” European capital market in which the Pfandbrief has to stand up to competition?
- And what are the global perspectives of the Pfandbrief market, the subject of today’s conference?

2. What changes have now taken place in the capital markets following the introduction of the euro?

The most important consequence of the introduction of the euro on 1 January 1999 has certainly been the elimination of the exchange-rate risk, which, up to the beginning of the monetary union, was an important reason for the segmentation of European financial markets. The euro area has now become the second largest bond market after the US. The euro area countries have a share of slightly less than one-quarter of the worldwide bond markets.

The reasons for this were the conversion of bonds in circulation at a very early stage and very buoyant issuing activity in the first few months of monetary union. The distinction between domestic, foreign and Eurobonds has become largely meaningless. The single currency offers issuers a broader financing base and allows investors to choose from a much wider range of bonds and stocks in which they can invest without an exchange-rate risk.

The convergence of the national markets to form a large and liquid European capital market, however, is a process which is not yet complete. Many private investors still prefer to invest nationally. It is primarily large enterprises that have benefited so far from the freedom of the enlarged markets when taking up funds.

Even so, competition is well under way. Issuers are compelled to gear their issuing policy more closely to the requirements of international investors. Banks and European stock exchanges and financial centres are also feeling the higher wind speed of competition in the euro area. The euro zone has accelerated the change engendered by the advance of globalisation; in a sense, European financial markets are undergoing a dual process of radical change.

Many enterprises are finding that the larger and more liquid Euro capital market offers more favourable financing conditions than traditional financing via a bank loan. Therefore, powerful borrowers are reconsidering their method of refinancing and are more and more taking the direct route to the capital market and the financial service providers operating there. The disintermediation of the banks in the wholesale market is increasing. Securitisation is intensifying competition among the banks and is having a crucial impact on the structure of the banking system.

Competition among financial centres has become harder as well. In securities business, the costs and the transparency of the trading platforms as well as the efficiency of the settlement systems have become increasingly important in choosing which financial centre to use. Thus, competition among financial centres is increasingly also becoming a competition among systems. Now that the triumphant progress of computerisation has become unstoppable, the race for the establishment of electronic trading systems has become more heated. Fiercer competition, in terms of both products and costs, has necessitated concentration and cooperation. The splitting up of the trading platforms for the spot and futures markets into individual markets and the fragmentation of settlement systems with inefficient and cost-ineffective settlement procedures, especially those for cross-border securities trading, are no longer suited to the age of the single currency.

3. Addressing the issue of the global perspectives of the European financial markets, in general, and the Pfandbrief market, in particular, requires a brief review of the developments in the European financial markets since 1 January 1999.

In the **money market**, the changeover to the euro and to the single monetary policy has taken place rapidly and smoothly. The development of a single European money market made such progress during the first nine months of monetary union that it can now be described as integrated and liquid. This is a crucial factor both for the ECB's monetary policy, which is geared to the stability of the euro, and for the development of the European capital market.

A key factor contributing to the rapid integration of the Euro money market is the TARGET system. TARGET's main objectives for the monetary policy of the Eurosystem and the Euro money market have been achieved; the provision of a safe and reliable mechanism for the settlement of cross-border payments and a rapid and effective increase in the efficiency of cross-border payments within the EU. In July, a daily average of slightly more than €350 billion was transacted via the TARGET system.

The Eurosystem's monetary policy instruments are working smoothly. The main refinancing operations are fulfilling the functions assigned to them, which is to signal the monetary policy stance, to steer the money market rates and to supply the banking system with the bulk of liquidity.

Supplying the banking system with liquidity on a more sustained basis through the longer-term refinancing operations is not posing any problems either. The standing facilities have effectively limited the overnight interest rates. The averaging provision applying within the minimum reserve system has contributed to smoothing out daily fluctuations of liquidity. Previous experience has shown that the Eurosystem's operational framework constitutes an effective set of instruments for steering money market rates and limiting their fluctuations.

By the way, it seems remarkable to me in this context that the dispute over the benchmark rate in the Euro money markets was resolved in favour of the EURIBOR far more quickly than many market participants had expected. The day-to-day money market rate for the euro (EONIA), which is ascertained by the ECB, has established itself as a representative picture of the market conditions in the euro area. EONIA and EURIBOR cover the whole range of the Euro money market reference rates in a consistent manner.

For the Pfandbrief market, it was crucial in connection with the decisions on the monetary policy instruments that Pfandbriefe were included in the list of tier-one assets and were thus treated "neutrally" in monetary policy terms relative to government bonds. This status has certainly benefited the competitive position of the Pfandbriefe by increasing its liquidity.

The **bond markets** had already partly anticipated the introduction of the euro, although, in the final analysis, the euro bonds issued prior to the start of monetary union were nothing other than ECU bonds with the pre-announced conversion rate of 1 to 1.

The decision taken by the major issuers to redenominate bonds in circulation from the national currency to euro at the beginning of January this year and to standardise the very different market practices in Europe on internationally consistent market conventions resulted almost overnight in the emergence of a large and liquid Euro-bond market.

In this context, all the market participants were focusing their attention on the question of who would set the benchmark for the euro area. Even in the run-up to monetary union, competition among public issuers had increased owing to the forthcoming abolition of the exchange-rate-induced yield differentials. The German Federal Government positioned itself at an early stage for the changed competitive situation and, in cooperation with the Bundesbank, took a number of measures to enhance the attractiveness of its bonds. These measures included, in particular, concentrating the instruments on the five major maturity ranges (six months, two, five, ten and 30 years), increasing the volume of individual issues, concentrating the Federal Government's and its special funds' borrowing on the uniform issuer's name "Federal Republic of Germany", introducing the stripping option in order to capture the yield curve as completely as possible, and introducing a transparent and efficient issue method.

Further improvements are currently under discussion, for example, with respect to the five-year "Bobls", whose present dual role as paper for small private investors and for institutional investors is criticised by major market players.

These measures have enabled Germany to set the benchmark in the important ten-year maturity range. At the same time, the Bund future has risen to become the most-traded futures contract in the world. Incidentally, the market for "Jumbo Pfandbrief Bonds" has also benefited from the benchmark role of the German Federal bonds. This market seems to have good prospects of assuming the benchmark function within the Euro-spread markets in terms of liquidity, credit standing and the stability of the spread over Federal bonds.

The **equity markets** cannot yet keep up with the Europe-wide performance of the money and bond markets. The stock exchange environment in Europe with its differing rules and regulations is still heavily fragmented. With more than 30 stock exchanges, Europe has an enormously high density of such places. The associated fragmentation of liquidity is naturally not conducive to an efficient and transparent price formation process. Different underlying legal and tax conditions as well as different accounting rules also hinder the process of growing together to form a single European equity market.

Integration and/or harmonisation is a slow-moving process in this instance, because company, tax and balance sheet laws are integral parts of each national legal system with its own history and tradition. Adjustments and amendments are bound to have an impact on other areas of legislation, too. Regulations which differ from country to country therefore constitute major obstacles to the integration of the markets.

The European Commission recently pointed out in a note to the Council and the European Parliament that the differing taxation of investment income, differing accounting standards and differing rules for supervision are major obstacles to a complete integration of the European capital markets.

There are signs of progress, at least in some areas; a case in point are the efforts being made by the Forum of European Securities Commissions (FESCO). But the stock exchanges themselves are also called upon to play their part in the necessary consolidation of the market structures and to set aside national interests; today, no European stock exchange can any longer afford to pursue "go-alone" strategies. It now seems foreseeable that the infrastructure of a European stock exchange network will be an electronic one. Local stock market centres are diminishing in significance to the extent that modern technologies are increasingly allowing market participation from any desired location. It appears that all parties involved have now recognised these developments and started to act accordingly.

4. What are the conclusions to be drawn from this brief review of the European financial markets nine months after the start of monetary union?

The integration of the money markets may be regarded as almost completed. It is far advanced in the bond market. The stock market still has the largest need for adjustment. As a result, it is primarily in the stock market that market forces are currently working for change. The recent decision made by European stock exchanges on the creation of a "virtual" cross-border-market is evidence of this. The common market model presented last week should be an interim solution only. It is in the interest of the economy as a whole that efforts to create a single European stock market with a single trading platform make progress. In the long term, investors and issuers will not be content with fragmented markets.

An efficient and competitive stock exchange in the euro area also needs efficient clearing and settlement. Experience gained in the United States shows that concentrating on a comprehensive settlement system with a settlement platform which is also competitive worldwide is necessary for this. The trend is already clearly towards a consolidation of the many different existing clearing systems in the euro area, which will then also permit closer links between trading and settlement.

An initial major step towards the necessary concentration of clearing and settlement systems has been made with the merger of Cedel International and Deutsche Börse Clearing. It would be desirable that at the end of the integration process, there would be a European stock market with a single European settlement system. In all cases, the central banks are closely watching the continuing developments.

Although the harmonisation efforts in the bond markets are more advanced than those on the stock markets and stock exchanges, this does not mean that the developments triggered by monetary union have already come to an end there. The rapid rise in cross-border capital flows continues to boost competition. In addition, in view of the still relatively low level of interest rates, investors are increasingly looking for spread products which offer a higher yield than government bonds. Despite the considerable progress made in convergence during the run-up to monetary union, European government bonds are still showing yield spreads which are mainly due to the different levels of liquidity and credit standing. But these have now become so small that they offer investors hardly any interesting opportunities for diversification in terms of spreads.

This may be unsatisfactory for the smaller member states of monetary union which have difficulties in ensuring sufficient market liquidity over the entire range of the yield curve. However, I believe that the proposal of conducting joint securities issues of the EU countries through a single issuance agency has little chance of success. Experience of corresponding issues by German federal states has shown that even minor differences in credit standing between the individual debtors behind the single credit financing lead to a divergence of interests and make any agreement on a single issue project virtually impossible. In addition, there are legal and practical problems, such as the lack of a legal basis for joint liability for such single issues which make a proposal of this kind appear not very realistic. Competition should therefore be maintained among public sector issuers. In the interest of efficient markets, competition ensures that public sector debt management has to strive continually for borrowing at the lowest costs possible. This is the only way of maintaining the discipline which the market imposes on the public sector through country-specific spreads.

The situation is no different in the market for Pfandbriefe. Foreign Jumbo mortgage bonds, which rely heavily on the legal basis of the German Mortgage Bank Act, have been forcing their way into the international capital markets for the first time during the past few weeks. The market for spread products, into which yield-oriented investors can diversify their investments, is hence becoming increasingly diverse and competition for German Pfandbriefe is intensifying.

The market for corporate bonds has been growing strongly in Europe but not as strongly as predicted by optimistic forecasts. In the longer term, however, financing via bonds is likely to become a worthwhile alternative for enterprises. The market for corporate bonds might receive an additional boost from the persistent wave of mergers in Europe. Financing of corporate mergers is often only possible through borrowed funds which are likely to be increasingly financed by the issue of corporate bonds. Finally, investors who are looking for new yield and diversification opportunities will possibly step up demand for higher-yielding bonds.

There are hence signs that, from a spread point of view, corporate bonds might become the most important investment category competing for investors in the future European bond market alongside government bonds, Pfandbriefe and bank bonds. Other products, such as asset backed securities or high-yield junk bonds, are also likely to gain in importance.

The German Pfandbrief market offering high creditworthiness and liquidity as well as high-yield premiums compared with government bonds has good prospects of becoming the most important spread market in the euro area. The example of the US agency market has shown that high market liquidity, representation of the entire yield curve and the transparency of the issuing policy are crucial factors for a successful positioning in the spread market ranking. The German mortgage banks have already successfully tapped this potential over the past few years by a corresponding expansion of their product range and a commensurate marketing strategy.

5. Up to the end of last year – as I have already mentioned – the German capital market and its most important products, the Federal Government bonds and the Jumbo Pfandbriefe benefited crucially from the stability of the D-Mark. In the same way, the development of the European capital market will hinge on the stability of the euro and on international investors' confidence in the stability policy of the European Central Bank.

To a certain extent, monetary policy and the capital markets are mutually dependent: the capital market needs a stable currency, since monetary stability is the foundation on which the capital markets can flourish. It encourages savings and makes a crucial contribution to long-term capital formation. It improves the real performance of financial assets and thus makes a flight into material assets superfluous.

Conversely, efficient, highly competitive and stable financial markets are of great importance for the implementation of monetary policy. It is true that the capital market is not the direct area of operations for monetary policy. That is the money market. But a successful central bank policy depends on the predictable and rapid transmission of its measures through efficient and stable financial markets as a whole, which means the money and capital markets.

The independence of the European Central Bank, its commitment to a stability-oriented monetary policy and the strict criteria of the Maastricht Treaty are a sound basis for an enduringly stable single currency. It is true that the euro has lost in value against the US dollar on foreign exchange markets since the beginning of the year. I will not make any comments on this here. Enough has been said on this subject by competent and sometimes not-so-competent commentators. The rapid growth of European interest-rate markets and the high buoyancy of the European capital market in the first nine months of monetary union do not suggest that there is a very pronounced lack of confidence in the euro.

The future development of the euro as an international investment and issuing currency will be decided primarily by the markets. The preconditions for continued growth of the euro financial markets are good. The euro capital market offers private issuers of debt securities and equities considerable advantages. The greater number of issuers and investors who settle their transactions in the same currency enhances liquidity and allows larger issue volumes. This reduces refinancing costs. The larger currency area will in the future also attract new investors and issuers to the capital markets in the euro area. German mortgage banks have positioned themselves early for this development, the jumbo Pfandbrief is outstandingly well-suited to the changed environment of monetary union. The global perspectives for Europe’s biggest bond market therefore hold out a great deal of promise.