Mr Noyer gives an address on the outlook for the euro area economy and its financial markets

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the “Cérémonie de remise des Victoires des SICAV”, Paris, on 24 February 2000.

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I am very pleased to address this distinguished audience of fund managers today and to witness the presentation of awards for excellence in financial innovation. It is my belief that the process of financial innovation in general, as celebrated in today’s ceremony, deserves particular attention. This is because improvements in the working of financial markets will eventually improve the allocation of financial resources in the economy, which will in turn be beneficial for sound economic growth over the medium term.

1. Trends in 2000 for the euro area economy

In the first part of my address today, I would like to discuss the major trends in monetary, economic and financial developments in the euro area in 2000. I will examine these trends within the framework of the Eurosystem’s monetary policy strategy.

The primary objective of the Eurosystem is to maintain price stability over the medium term. Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. The assessment of risks to price stability in the context of the monetary policy strategy is based on two pillars. First, a reference value of 4½% for the growth rate of the broad monetary aggregate M3; second, a broadly based assessment of the outlook for price developments and risks to price stability in the euro area. To begin with, let me consider the *first pillar* of the strategy. In 1999, the three-month average of annual percentage growth rates of M3 was consistently above the reference value. Over recent months, both money growth and the growth of credit to the private sector signalled generous liquidity conditions in the euro area and were seen as posing upward risks to price stability.

Let me now turn to the *second pillar* of the monetary policy strategy, the broadly based assessment of the outlook for price developments and risks to price stability in the euro area. Various macro-economic indicators available for the euro area consistently point towards a strong cyclical upswing in the euro area in 2000. These expectations for developments in economic activity in the euro area are supported both by external developments, as the outlook for global economic activity is improving, and developments internal to the euro area. At the same time as the cyclical upswing started to materialise, however, increases in consumer prices over recent months were relatively large and protracted. This reflected mainly the impact of increasing oil prices seen throughout 1999 as well as, following the continued depreciation of the effective exchange rate of the euro, increases in import prices. These increases in oil prices and in import prices led to a situation where there were increasing risks of second round effects on consumer prices.

With respect to both the first pillar and the second pillar of the strategy, developments over the last few months led the Governing Council of the ECB to raise interest rates. The main refinancing rate was raised to 3% on 4 November 1999 and then to 3.25% on 3 February 2000. By raising interest rates in view of the developments that I just described, it was aimed to contribute to ensuring that the cyclical upswing currently under way in the euro area will be both strong and sustainable, because it will occur in an environment of price stability over the medium term.

Over the next months it is particularly important that social partners keep wage increases in line with price stability as well as being supportive of further growth in employment. The rate of unemployment in the euro area has fallen throughout 1999 but still remains high. A lasting reduction in unemployment could be achieved only if further progress is made in structural reforms aimed at promoting flexibility on the labour market, providing jobs to low skilled workers and facilitating the return to the job market of the long-term unemployed. In addition, the growth prospects of the euro area over the medium term would clearly benefit from the completion and further deepening of structural reforms promoting competition on the markets for goods and services.

2. Euro area financial markets

Also for the financial markets of the euro area, structural reforms aimed at promoting competition appear to be necessary. These reforms will over time contribute to improving the working of financial markets integrated at the area-wide level. Furthermore, the Eurosystem has an obvious interest in well functioning and efficient financial markets because financial markets are the conduit through which monetary policy decisions are channelled into the economy. Let me consider first the *money market*. In 1999, within the euro area cross-border operations constituted a large share of all operations on the money market. The market has evidently benefited from the creation of a strong and secure backbone of payment systems, including the real-time gross-settlement system operated by the European System of Central Banks (ESCB). The money market of the euro has widely used daily reference indices for interest rates, notably EONIA for overnight transactions and EURIBOR for transactions at longer maturities. A full set of standard instruments is built upon these reference indices, in particular money market futures and options contracts as well as short-term interest rate swaps. This leads to a situation where market participants are able to manage their day-to-day funds in an efficient manner and at relatively low costs. Important progress remains to be achieved, however, in particular for instance with regard to the repo market. The further integration of the repo market at area-wide level will benefit from the operation of common platforms for the clearing and delivery-settlement of securities used as collateral in repo transactions.

If I now turn to the *bond market* of the euro area, observations made during 1999 also seem to indicate that the market is already relatively well integrated at the level of the euro area. As shown by the newly published ECB statistics in this field, there was a considerable increase in the participation of private sector issuers in the bond market in 1999. To some extent, this development appears to have been linked to higher mergers and acquisitions activity. Furthermore, the volumes of transactions on both the secondary market for bonds and on the markets for interest rate derivative products also appear to have increased in 1999. In this context, the more sophisticated market participants seem to be able to easily take positions at any point on the term structure of interest rates, thus contributing to the formation of representative and reliable prices for the entire range of instruments available on the euro area bond market. These observations tend to indicate that the bond market of the euro area has attained a good degree of depth and liquidity.

Further progress towards the constitution of very efficient bond markets in the euro area can, however, certainly still be made.

In the run-up to Stage Three of European Monetary Union, bond market participants in each country of the euro area appeared to increasingly hold bonds issued in other countries of the euro area. This development reflected notably the decline in spreads linked to the expected removal of intra-area exchange rate risks. Following the creation of the euro, bond market investors are naturally not concerned with intra-area exchange rate risks any more. Instead, they seem to focus on an assessment of the intrinsic credit quality of issuers. Thus, the assessment of credit quality and the development of a “credit risk culture”, which constitute important features of an active and open bond market, are likely to develop further partly as a result of the creation of the euro. The activities of ratings agencies make it possible to define common standards for the assessment and comparative ranking of the credit quality of borrowers and issuers. In this regard, it is interesting to note that, in 1999, the share of relatively low-grade borrowers in new bond issues, although it remained small, seemed to increase somewhat. Over the medium term, in the context of the further development of a “credit risk culture”, it can therefore be expected that the bond market of the euro area will become increasingly diversified, in particular with regard to the range of participating issuers, and attract more private issuers.

With regard to the *stock market*, similar observations may be made. In particular, the development of a range of area-wide stock market indices is indicative of the progress made in the integration of euro area stock markets. In particular, stock market participants seem to increasingly take into account the economic factors common to the euro area as a whole. Furthermore, the integration of stock markets at the euro area level means that issuers across the euro area have privileged access to a large number of investors on a large and open market place. This perspective is certainly a supporting factor for the development of segments of the stock market dedicated to relatively small and/or new firms, the so-called “new markets”.

I would like to conclude this brief discussion of trends in euro area financial markets with a reference to the - admittedly still timid - emergence of new market places operating on the internet. It appears that internet market places have the potential to cover a broad range of activities, both on the so-called primary market at the time of issue of new securities and on the secondary market. One of the advantages of these new market places is that they may be accessed by a very wide range of users because they take advantage of an existing communication network infrastructure, the internet. Furthermore, the new internet market places also seem to be characterised by a high degree of automation of trading processes. These factors would seem to make it possible to achieve lower transaction costs and, more generally, contribute to further improving the working of financial markets.