Willem F Duisenberg: The role of financial markets for economic growth

Speech delivered by Dr Willem F Duisenberg, President of the European Central Bank, at the Economics Conference "The Single Financial Market: Two Years into EMU", organised by the Oesterreichische Nationalbank and held in Vienna, on 31 May 2001.

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Introduction

It is a great pleasure and honour for me to join the Oesterreichische Nationalbank for its 2001 Economics Conference on "The Single Financial Market: Two Years into EMU". I would like to take the opportunity today to talk about the role of financial markets for economic growth. I shall first consider whether the design of the financial system matters for economic growth. Secondly, I shall say a few words about where the euro area financial system is heading, two years after the introduction of the euro. After this I shall discuss the role of monetary policy in the interplay between financial markets and economic growth. Towards the end, I shall address, as just mentioned by Governor Liebscher, the role of central banks in prudential supervision.

Does the financial system matter for economic growth?

In the financial system funds flow from those who have surplus funds to those who have a shortage of funds, either by direct, market-based financing or by indirect, bank-based finance. The former British Prime Minister William Gladstone expressed the importance of finance for the economy in 1858 as follows: "*Finance is, as it were, the stomach of the country, from which all the other organs take their tone*."

The financial system comprises all financial markets, instruments and institutions. Today I would like to address the issue of whether the design of the financial system matters for economic growth. My view is that the answer to this question is yes. According to cross-country comparisons, individual country studies as well as industry and firm level analyses, a positive link exists between the sophistication of the financial system and economic growth. While some gaps remain, I would say that the financial system is vitally linked to economic performance. Nevertheless, economists still hold conflicting views regarding the underlying mechanisms that explain the positive relation between the degree of development of the financial system and economic development.

Some economists just do not believe that the finance-growth relationship is important. For instance, Robert Lucas asserted in 1988 that economists badly over-stress the role of financial factors in economic growth. Moreover, Joan Robertson declared in 1952 that "*where enterprise leads, finance follows*". According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands.

Other economists strongly believe in the importance of the financial system for economic growth. They address the issue of what the optimal financial system should look like. Overall, the notion seems to develop that the optimal financial system, in combination with a well-developed legal system, should incorporate elements of both direct, market and indirect, bank-based finance. A well-developed financial system should improve the efficiency of financing decisions, favouring a better allocation of resources and thereby economic growth.

Both market and bank-based financial systems have their own comparative advantages. For some industries at certain times of their development, market-based financing is advantageous. For example, financing through stock markets is optimal for industries where there are continuous technological advances and where there is little consensus on how firms should be managed. The stock market checks whether the manager's view of the firm's production is a sensible one. For other industries, bank-based financing is preferable. This holds in particular for industries which face strong information asymmetries. Financing through financial intermediaries is an effective solution to adverse selection and moral hazard problems that exist between lenders and borrowers. Banks in particular have developed expertise to distinguish between good and bad borrowers. Economies that have both well-developed banking sectors and capital markets thus have an advantage. Furthermore, in times of crisis in either system, the other system can perform the function of the famous spare wheel.

The financial system is also particularly important in reallocating capital and thus providing the basis for the continuous restructuring of the economy that is needed to support growth. In countries with a highly developed financial system, we observe that a greater share of investment is allocated to relatively fast growing sectors. When we look back more than one century ago, during the Industrial Revolution, we see that England's financial system did a better job in identifying and funding profitable ventures than other countries in the mid-1800s. This helped England enjoy comparatively greater economic success. The banker and former editor of "The Economist" Walter Bagehot expressed this in 1873 as follows. "*In England, however, ... capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level*".

Nowadays, the lack of a well-developed stock market would be a particularly serious disadvantage for any economy. Equity is essential for the emergence and growth of innovative firms. Today's young innovative high-technology firms will be the main drivers of future structural change essential for maintaining a country's long-term growth potential. The contribution of financial markets in this area is a necessity for maintaining the competitiveness of an economy today given the strongly increased international competition, rapid technological progress and the increased role of innovation for growth performance.

In recent years, "new markets", for stocks of young and growing companies, have become a growing market segment in the euro area. Equity financing is particularly advantageous for these companies and their investors given the uncertainties of the economic return. As the term "shares" suggests, with equity financing you get your share of the outcome, whether it is positive or negative. Banks, on the other hand, may be reluctant to provide loans owing to the risk profile of these firms, and the greater exposure to a negative result in a loan contract.

Total market capitalisation of the new markets in five euro area countries grew from EUR 7 billion at the beginning of 1998 to EUR 167 billion in December 2000. While some of this increase can be attributed to the overall rise in share prices during this period, it is important to note that the number of listed companies continued to increase in almost every month. The total number of companies listed on these new markets in the euro area increased from 63 at the beginning of January 1998 to 564 at the end of 2000. Developments over the last year have admittedly been dismal. However, it is the nature of new markets, given the uncertainties attached to future developments for the companies listed on these markets, to exhibit more volatility than established markets.

Bank-based finance has a special role to play for many companies in need of funds, and thus helps to ensure a well-balanced growth process. The economic literature on "relationship banking" has demonstrated that banks can contribute to alleviating the impact of sudden economic shocks on their clients. Banks stand ready to provide many customers with funds even in adverse circumstances, e.g. when the liquidity of financial markets dries up.

The banking sector also has an essential role to play with respect to the allocation of funds to the most profitable investment opportunities. Banks are, as mentioned before, financial intermediaries that by nature add cost to the allocation of capital. Thus in order for banks to survive in a market economy they need to provide added benefits. It is difficult to compete with the debt securities market, if a bank loan is of a size where the fixed costs of accessing debt markets become negligible. However, securities markets are not always sufficiently liquid and some, especially small and medium, enterprises cannot cover their liquidity needs via securities markets owing to significant fixed costs of access. An additional benefit of bank-based finance relates to the intrinsic nature of the banking business: some projects cannot be financed directly by the market on account of significant information asymmetries between the borrowers and potential lenders. Banks can bridge this gap thanks to their comparative advantages in the assessment and monitoring of investment projects, which contributes to overcoming information asymmetries.

The financial system of the euro area after two years with the euro

Let me now turn to the major changes of the financial system in the euro area after two years with the euro.

Financial market integration

The launch of the euro on 1 January 1999 was a historic event. Eleven national currencies were converted into one single currency overnight. Greece became the twelfth EU Member State to adopt the single currency on 1 January 2001. The newly created currency area of the twelve participating European Union Member States has a considerable weight in the world economy. It accounts for around 20% of world GDP and world exports. The successful launch of the euro, which is a key element in the creation of a stable and prosperous Europe, has boosted the integration of financial markets in the euro area. This process of integration in European financial markets coincided with the trends towards globalisation and securitisation. Other factors, among a wide range, which shape the financial system are historically determined characteristics, technological innovations, monetary and fiscal policies and specific legal and accounting systems that differ from country to country.

Evidence of integration can be found, to varying degrees, in all parts of the financial system. The euro area money market is among the most integrated parts of the financial system. The conduct of one common monetary policy in the euro area brought about immediate integration of the unsecured segments of the money market, mainly the interbank market and the short-term derivatives market. The secured segments of the money market, that is the repo market and the markets for short-term securities, are also increasingly integrated, but they still suffer from underlying problems with the management of collateral. Nonetheless, the outlook is promising. The euro area bond market has also developed rapidly. Notably, the private segments of the euro area bond market have flourished since the introduction of the euro. The amount outstanding of long-term debt securities issued by the private sector was 22% higher at the end of 2000 compared with the end of 1998. Probably the most significant development has been the rapid growth in the euro-denominated corporate bond market, which has increased several-fold in size since the launch of the euro and is now characterised by issues of above EUR 1 billion. EMU has also stimulated integration in the stock markets in the euro area, where structural developments have been dominated by a series of high-profile mergers and attempted mergers.

Regulatory framework

The rapid growth achieved by European securities markets has taken place notwithstanding remaining regulatory obstacles to their integration. The European authorities are fully aware of the need to address this problem. Several obstacles have been identified in the recent Report of the Committee of Wise Men, chaired by Alexandre Lamfalussy. The Committee proposes to speed up the removal of impediments through the institutionalisation of two new regulatory committees for securities markets, which should allow for an increased harmonisation of securities regulation and less burdensome procedures for adapting Community rules to rapidly changing financial markets.

Another essential European initiative was the adoption by the Commission, in May 1999, of a programme for the completion of the Single Market for financial services. This programme, the Financial Services Action Plan, lists a series of measures with indicative priorities and timetables. The project considered as a whole and its inherent philosophy are capable of enhancing economic growth. In this perspective, a handful of specific initiatives deserve a particular mention. A first initiative is the adoption of the European Company Statutes, which is essential to enhance the level-playing field between European firms and to provide a suitable legal framework for transnational conglomerates. A second important aspect is the Risk Capital Action Plan, which would help redirect financial flows towards fast-growing small and medium-sized enterprises. Let me also mention the last four initiatives, namely the e-commerce policy for financial services; the harmonisation of rules on the accounting requirements for European companies; the takeover bids Directive; and finally the removal of accounting, legal and fiscal discrepancies hindering the cross-border use of collateral. A European Directive on this subject should be adopted in 2003.

Many of these initiatives may appear to be unimportant and somewhat "esoteric" regulatory changes. However, they can provide a real boost to the smooth operation of markets and, therefore, to economic growth. For example, obstacles to the cross-border use of collateral prevent the further cross-border integration and consolidation of clearing and settlement infrastructures, thus hindering the integration of European money, bond and equity markets. A smooth electronic integration of trading, clearing and settlement operations would help reduce transaction costs substantially. The gradual dismantling of regulatory obstacles to remaining market integration in Europe will contribute to enhancing their depth and efficiency, in turn contributing to an improved allocation of funds to the most profitable investment opportunities, and thus supporting economic growth.

What is the role of monetary policy and central banks?

Price stability

The interaction between financial markets, economic growth and monetary policy is by no means a new issue for central bankers. However, financial market developments have brought the question to the forefront of the policy debate. The continued integration and deepening of financial markets is a significant issue for policy-makers, and particularly for central bankers, since smoothly functioning and efficient financial markets are crucial in ensuring a smooth transmission of monetary impulses.

The best contribution that monetary policy can make to the smooth functioning and integration of European financial markets and to economic growth is to maintain a steady medium-term price stability orientation. Such a policy will be beneficial, as it will minimise the adverse effects of inflation and high inflation uncertainty. As we all know, price stability is beneficial in numerous ways. It not only creates a climate for higher economic activity over the medium term, but also reduces the economic and social inequalities caused by the asymmetric distribution of the costs of inflation among the various economic agents. In addition, in an environment of low inflationary expectations, inflation risk premia become relatively less important as a determinant of financial prices. As a result, other factors such as credit risk can play a larger role in the price formation mechanism. Ultimately, this results in a more efficient allocation of financial resources.

The approach of focusing on price stability is by now the conventional wisdom in industrialised countries. In the case of Europe, this consensus on the contribution of price stability in the medium term to promoting long-term growth is explicitly enshrined in the Statute of the ESCB, which states unambiguously that "the primary objective of the ESCB shall be to maintain price stability in the medium term." The ECB is convinced that by rigorously fulfilling this mandate, monetary policy is making its most effective contribution to the realisation of strong output growth and satisfactory employment prospects.

Financial stability and the role of central banks in banking supervision

Also the design of prudential regulation plays an important role from a growth perspective. Supervision is the guardian of financial stability, which in turn crucially determines the capability of the financial system to allocate resources efficiently and absorb liquidity shocks. Financial crises can have a deep and protracted impact on economic growth, as illustrated by several episodes of financial instability that occurred in many countries. The contribution of prudential supervision to economic growth proceeds along two dimensions. From a preventive perspective, supervision has to ensure a continuous and comprehensive monitoring of all the potential threats to financial stability. The role of supervision is also crucial after the emergence of a crisis, in order to provide for a swift and ordered resolution. Supervisors can only be effective in these two respects if they are able to pay sufficient attention to systemic issues, namely the risk of contagion effects. In order to address this issue in an effective way, they should be able to bridge the gap between information of a micro-prudential nature, namely information on the safety and soundness of individual institutions, and macro-prudential analysis, which encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to financial stability arising from macroeconomic or financial developments.

This line of argument would support a large role for central banks in supervision, since they have traditionally played a large role in macro-prudential analysis and the preservation of financial stability and they have acquired a strong expertise in this field. Furthermore, smooth access of central banks to micro-prudential information would also be profitable from the perspective of another traditional central banking task, namely the oversight of payment systems.

In spite of these arguments supporting a large role of central banks in supervision, the debate has remained broadly inconclusive in the economic literature so far, owing to the existence of opposite considerations. The first important argument against a large role for central banks is the so-called "conglomeration argument", which crucially relies on the idea of a blurring of distinction between banking, insurance and securities firms. In order to preserve the level-playing field, all segments of the financial industry would have to be supervised under the aegis of a common supervisor. According to this line of reasoning, this "umbrella" could not be the central bank, since the latter is traditionally in charge of supervising monetary organisations. I will not embark upon a thorough analysis of this issue now. Let me just say that I am convinced that this argument has lost relevance in the current context characterised by a more market-based conduct of supervision – which alleviates the level-playing field concern - and by an increased relevance of systemic risk issues.

The second major argument against a large involvement of central banks in supervision is the alleged conflict of interest between monetary policy and prudential supervision. Many authors have argued that the institution in charge of monetary policy cannot be entrusted with supervision, because the monetary policy stance would be "contaminated" by supervisory issues, for instance the need to safeguard the liquidity of individual banks.

The advent of the euro, however, has shifted the balance of arguments decisively in favour of a large involvement of national central banks (NCBs) in supervision, for two main reasons. *First*, the argument of a conflict of interest between monetary policy and prudential supervision becomes irrelevant within the euro area, where supervisory responsibilities are at the national level. Since the geographical jurisdictions of monetary policy and prudential supervision no longer coincide, NCBs in charge of prudential supervision are shielded from the traditional conflict of interest.

The *second* key factor is the increased relevance of systemic risk since the advent of the euro. The nature and scope of systemic risk have changed in a decisive way. A first decisive evolution is the *growing integration of European financial markets* in the euro area. As I have already mentioned, the interbank market, especially the unsecured segment, is already fully unified across the area owing to the disappearance of the currency risk and the connection of national real-time gross settlement systems via TARGET, the large-value cross-border payment system of the Eurosystem. A second key evolution from the perspective of systemic risk is the *growing merger and acquisition activity and the trend towards the emergence of financial conglomerates in Europe*, which has, for instance, been identified in a recent G10 report on consolidation in the financial sector. In this new environment, financial institutions are increasingly involved in intricate networks of counterparties in the interbank market and via payment and settlement systems, and the impact an unwinding of their positions could have on asset prices becomes even more ambiguous. These interrelations have a more international character than before the advent of the euro, which implies that supervision has to pay much more attention to euro area-wide developments. The national central banks of the euro area have a comparative advantage in this field owing to their responsibilities over payment and settlement systems, their traditional focus on systemic risk and their role as components of the Eurosystem.

My conclusion is that the successful pursuance of financial stability in Europe, which is a prerequisite for economic growth, could benefit considerably if NCBs maintain and even reinforce their role in prudential supervision. The debate on the organisation of banking supervision seems to be taking a different course for the moment at least in a few euro area countries. Institutional arrangements based on a single supervisory authority for the financial systems as a whole *seem* to have gained momentum over the past months in some euro area countries like Ireland and Finland, and also in your country, Austria, where a single supervisor for banking, insurance, securities and staff pension funds (*Pensionskassen*) should be established early 2002 according to the recent draft Financial Market Supervisory Authority Act ("Finanzmarktaufsichtgesetz").

At first sight, this evolution runs counter to the need for a larger involvement of NCBs in prudential supervision. However, in this field implementation details are crucial. In particular, it is crucial that effective provisions for a close co-operation and a smooth exchange of information between the separate supervisory authority and the NCB are laid down. NCBs should in any case be entrusted with the task of safeguarding financial stability of the system as a whole and endowed with the instruments needed to pursue such an objective effectively. In this respect, an extensive operational involvement of NCBs in the conduct of prudential supervision is a key factor.

Conclusions

In concluding, I believe it is fair to say that EMU has already had a profound impact on the process of EU financial integration. The impact of the introduction of the euro as a single currency of twelve Member States has created the potential for large, deep and liquid euro-denominated financial markets, which should help to deliver high rates of output and employment growth in the euro area economy. This transformation in the financial and economic landscape entails certain potential risks, but it will provide many opportunities for enhanced efficiency and growth in the financial markets and economies in the euro area. I am convinced that the latter will prevail.

Thank you very much for your kind attention.