

Willem F Duisenberg: Developments in international financial markets

Speech delivered by Dr Willem F Duisenberg, President of the European Central Bank, at the inauguration ceremony of the Second Swedish National Pension Fund, Gothenburg, 26 September 2001.

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Introduction

It is a great pleasure and honour for me to be here today at the inauguration ceremony of the Second Swedish National Pension Fund. My comments will not be directly concerned with developments in Swedish financial markets, but I will focus on trends and developments in the financial markets of Europe. Although Sweden is not part of the euro area, you should expect to benefit from any efficiency gains achieved in the capital markets of the euro area, both as a borrower and – perhaps of greater relevance to the pension fund industry – as an investor. I would like to concentrate my remarks today on three issues. First, I shall say a few words on the need to reform pension systems in Europe. Then, I would like to discuss recent developments in euro area capital markets from a global perspective. Finally, I shall address the issue of oversight of financial markets and recent institutional and regulatory developments.

Need to reform pension systems in Europe

Over the last fifty years we have witnessed an unprecedented era of growth, technological progress, prosperity and welfare improvement across all generations. Notable demographic changes are taking place not only in Europe but also across the western world and this raises many important issues. In particular, improving economic welfare has been associated with longer life expectancy. Combined with lower birth rates, this is leading to an ageing of populations, which will have far-reaching implications. It raises issues concerning possible resource constraints that may be faced in the future and questions about the sustainability of prevailing living standards in an environment where current projections point to a future population decline in Europe. Related to that is the issue concerning the sustainability of the current pension systems.

As members of the pension fund industry are undoubtedly aware, on current trends the ratio of elderly people to the working-age population is set to increase significantly. In the euro area, the ratio of over 65 year olds to those between 20 and 64 is forecast to rise from prevailing levels of 27% to around 53% by 2050, with a maximum of 67% in Italy. This is expected to result from a combination of effects. Most importantly, life expectancy has increased considerably over the last half century and this trend looks set to continue. At the same time, the number of births has declined substantially throughout the developed world and even a return to higher birth rates in the future would most likely come too late to solve the problems faced by many pension systems in the coming decades.

Pension systems in Europe rely heavily on state-run pay-as-you-go arrangements. Funded pension arrangements, be they publicly or privately managed, are generally less developed. Pay-as-you-go systems are particularly vulnerable to demographic change: with a declining ratio of the labour force relative to the number of pensioners, the tax base shrinks while the number of recipients increases, leaving policy-makers to adjust the system through reductions in benefits and increases in contributions.

It should be noted that debt financing of the gap between pension contributions and pension payments does not represent a viable alternative. Given the public knowledge of the pension system dynamics, participants in financial markets would anticipate the unsustainability of delaying pension system reform and require higher risk premia on new debt. In this respect, it is helpful that governments of the euro area have committed themselves to refrain from excessive public deficits through the Maastricht Treaty and the Stability and Growth Pact.

In order to deal with demographic changes, European governments are moving in several directions. So-called parametric reforms strive to put the existing pay-as-you-go systems onto a sound financial footing. They include changes to contributions and benefits, such as adjustments in the indexation of existing pensions and in benefit formulas for new pensioners. Two approaches are particularly noteworthy, and the Swedish pension reform has been impressive in this respect. The first is the

introduction of longevity adjustments in the benefit formula, which can insure the system against unforeseen – but welcome – increases in life expectancy after retirement. The second is the introduction of a notional defined contribution system which closely links an individual's contributions to his or her own future benefits. However, parametric reforms have limits: raising contribution rates would increase distortional taxation of labour with a negative impact on labour markets. Indeed, labour market reforms are also needed to counter the detrimental effects of the ageing of the population. One should, for instance, consider measures aimed at stimulating the supply of labour. Moreover, limiting benefits runs the risk of increasing poverty among the elderly.

An alternative and complementary route to securing future pensions consists in systemic reforms, namely a move toward more funded systems. This would partially replace labour taxation with an accumulated capital stock as the source of financing for pensions. Several countries, such as Denmark and the Netherlands, use private savings for future pensions. Germany is moving in the same direction after its recent pension reform. In Finland, a part of the social security contributions is channelled into a publicly administered fund. France has decided to create a fund equivalent to 10% of GDP by 2020. Ireland's public national reserve fund has assets of 7.5% of GDP, and the Irish government is committed to setting aside contributions equal to 1% of GDP up to 2025. Belgium has set aside revenues from UMTS licenses for such a fund. Sweden is obviously well advanced in this respect with a pension trust fund equivalent to 25% of GDP.

We should not be afraid of a stronger role for privately managed funded systems. Such systems have the advantage of efficient administration and an absence of political interference. They may also induce increased private savings. But suitable regulation must deter risky investment strategies that could jeopardise living standards at a vulnerable stage in people's lives and would discredit an increased role for the private sector.

The ageing of the population will also have a profound impact on budgetary policies, not only because of the consequences of population ageing on pension arrangements. Expenditure on healthcare is also expected to increase markedly. The potential impact of population ageing on the fiscal position of countries is an important reason why European countries should not only pursue balanced budgets, but also a surplus. This would allow them either to reduce their public debt, which would lead to lower interest payments and more scope for an increase in expenditure relating to population ageing, or to establish special funds to be used to finance this additional expenditure.

As a final remark on this particular issue, I would like to mention that population ageing is one of the broad economic trends shaping the future of financial markets in the euro area. Over the coming years, together with the liberalisation of financial markets, population ageing will lead to further demand for long-term investment instruments on the part of pension funds. In addition, the need for portfolio diversification may drive up the volume of cross-border investments, including investments in emerging markets with a more favourable demographic structure. These trends are likely to provide further impetus to the development of suitable financial instruments for pension funds, and more generally for savers at the end of the intermediation chain.

Developments in euro capital markets from a global perspective

I will now try to describe recent developments in euro capital markets from a global perspective.

The launch of the euro on 1 January 1999 was an historic event. Eleven national currencies were converted into one single currency overnight. On 1 January 2001 Greece became the twelfth European Union Member State to adopt the single currency. The newly created currency area of the twelve participating EU Member States has a considerable weight in the world economy. It accounts for around 20% of both world GDP and world exports. The successful launch of the euro, which is a key element in promoting economic stability and prosperity in Europe, has boosted the integration of financial markets in the euro area. This process of integration in European financial markets coincided with a trend towards globalisation and securitisation which was already well underway.

Since its inception, the euro has been the second most widely used currency at the international level. This reflects the importance of the euro area in the world economy. Recent trends in the internationalisation of the euro are the result of market developments and policies both inside and outside the euro area.

In capital markets the euro has seen a tremendous development in its short existence. This has been the case for both the bond and the equity markets.

The economies of, and the economic processes in, the countries currently within the euro area have become increasingly intertwined as we have moved towards EMU. This has naturally led to the development of more cross-border financial interconnections. At the same time, financial flows between the euro area and the rest of the world have increased rapidly in recent years. As far as euro area financial markets are concerned, the introduction of the euro acted as a catalyst for greater integration within the euro area, although this process is still far from complete. The improvement in efficiency which integration is bringing to financial markets in the euro area should be beneficial not only for euro area residents but also for non-resident borrowers and investors, who are able to access the financial markets of the euro area and take advantage of their breadth, depth and liquidity. In particular, even though euro area financial markets are not yet fully integrated at an area-wide level, they are larger and more accessible than any of the markets that were denominated in the predecessor currencies of the euro.

This has brought important benefits for residents of the euro area, but it also has important implications for Sweden. As regards to the bond market, I would like to share a number of more specific observations with you. The first is that the introduction of the euro created the second largest bond market in the world. The second is that, while the corporate bond market was of limited importance in the euro area before 1998, the launch of the euro seemed to act as a catalyst for the development of a market in which corporations could issue debt securities of unprecedented size. Reflecting this, the amount outstanding of debt securities issued by the non-financial corporate sector grew by an impressive 17% in 1999. The same growth rate was recorded in 2000 and – in the first six months of 2001 – growth rates of around 14% were observed. The wave of mergers and acquisitions in the euro area corporate sector seen since the launch of the euro provides just one example of the increased possibilities offered by the larger and deeper single financial market.

A third observation is the increasing importance of the euro in the overall stock of "truly international" debt securities. What I mean by "truly international" debt securities is those securities issued in a currency that differs from that of the country in which the borrower resides. By the end of 2000, the euro accounted for 26% of such securities. This share is 7 percentage points higher than the total share accounted for by the euro's predecessor currencies at the end of 1998. The share of the euro is even larger if account is also taken of the issuance of debt securities denominated in the home currency of the borrower and targeted at the international financial market. Furthermore, by virtue of its openness and its breadth, the bond market of the euro area has become an important component in international bond markets and can be expected to develop further in the coming years.

This picture of the euro bond market in terms of size, growth and international participation goes hand in hand with increased liquidity and efficiency. Over the past couple of years, this has resulted in declining transaction costs, as bid-ask spreads have narrowed. Furthermore, we have seen an increased diversity, due to the arrival of issuers with low credit ratings, which used to be all but absent in the euro bond market. This has increased the investment possibilities in the euro bond market.

Let me now turn to the stock markets. In the stock markets of the euro area there is also evidence of further integration. A number of benchmark indices now exist for the euro area as a whole. In addition, derivatives markets have been established which allow market participants to shift from taking a country perspective in their investment decisions to taking a sector perspective across the euro area. As a result, sectoral factors should play a greater role than before in determining share price movements over time.

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 in a large and open market place. This has paved the way for new firms and relatively small firms to obtain finance from stock markets that have specialised in providing funds to young and innovative firms. We have seen an astonishingly large number of new listings in recent years.

Oversight of financial markets and recent institutional and regulatory developments

Let me now turn to the issue of the oversight of financial markets and recent institutional and regulatory developments. The internationalisation of markets is posing new challenges for supervision.

The new challenges posed by recent market developments come mainly from two sources, technological advances and the increased competition and market integration triggered by the introduction of the euro. Until the 1980s, financial activity was conducted within heterogeneous frameworks. Each financial system was characterised by a different currency, legislation and

supervisory structure. In general, each sector of the financial industry – banking, securities and insurance – had its own supervisory agency. Financial innovation has significantly blurred the distinction between products supplied by different intermediaries, and technological advances have had a major impact on the importance of the physical location of the market players, since the two sides of the transaction and the intermediary need not be close geographically. The concept of the market itself has drastically changed, since it has become an entity not clearly identified by a physical location. For example, a large part of the regulation relates to the definition of a market as a physical entity. In today's financial systems it is possible to have markets, like the foreign exchange market, that do not have a geographical location. Public policies have progressively adapted to the new market environment, increasing cross-border and cross-sectoral co-operation between competent authorities and shaping new, less cumbersome and intrusive regulatory and supervisory tools. The introduction of the euro has further eroded sectoral and geographic segmentation, thus initiating debates in many countries on the most efficient institutional arrangements for prudential supervision and financial stability.

The single agency approach has recently gained ground as a response to the breakdown of sectoral distinctions in the financial industry. Sweden and Denmark within the European Union and Canada and Norway outside it were the first countries to adopt such a model. This solution attracted even more attention with the reforms in the United Kingdom establishing the Financial Services Authority. The developments which have occurred in the market seem to favour the single supervisor approach. In fact, financial products are now mixed and the same economic function is performed by contracts supplied by firms belonging to different segments of the financial industry. This implies that the traditional approach of specialised agencies is no longer perceived as satisfactory. On the other hand, the problems related to the creation and effective management of a universal agency are very complex. Indeed, co-ordination remains necessary, be it between specialised agencies or between the organisational units within a universal agency.

A second issue involves the role played by central banks. There are three main arguments in favour and three main arguments against the unification of prudential supervision and central banking. The arguments in favour are the following. First, there is a potential for exploiting synergies between the supervisory function and the core tasks of a central bank. A thorough understanding of the proper functioning of payment systems and of other market infrastructures is essential for the smooth conduct of monetary policy. Information collected for supervisory purposes may play a significant role in this. The second argument concerns the need to focus on systemic risk. Central banks have a privileged position from which to assess the impact of macroeconomic shocks and the financial stability of groups of intermediaries. The third argument concerns the independence from political interference and the technical expertise of central banks.

Similarly, we can identify three arguments supporting the establishment of a supervisory agency outside the central bank. The first one concerns the alleged conflict of interest between monetary policy and prudential supervision. Many authors have argued that the body in charge of monetary policy cannot be entrusted with supervision, because the monetary policy stance would be affected and it would pose a threat to price stability. A second argument is based on the observation that no clear distinction is made between the different financial products and intermediaries belonging to distinct financial sectors. I already discussed this argument earlier when I talked of the technological advances. The third and final argument concerns the need to avoid an excessive concentration of power in the central bank.

While it may be a difficult and controversial exercise to weigh up the pros and cons of the two solutions at a general level, without making allowances for the specific environment, in the particular context of the Eurosystem the balance of the arguments leans in favour of maintaining a strong role for national central banks in prudential supervision. The reasons for this are twofold. First, the conflict of interest regarding monetary policy and concentration of power is no longer relevant given the structure of the Eurosystem, since the introduction of the euro has implied an institutional separation between the monetary jurisdiction – the euro area – and the supervisory jurisdiction – domestically chartered institutions in individual countries. Second, in a single currency area in which financial markets are increasingly integrated, swift and open communications among supervisors are of vital importance for crisis prevention and management. The dual nature of national central banks, which are at the same time both national institutions and part of the Eurosystem, might be a valuable asset when dealing with cross-border or area-wide issues.

Conclusions

The implementation of the single market and the introduction of the euro have strengthened competitive pressure and increased flexibility in the EU economies. Furthermore, they have also had a clear impact on global markets, prompting further integration of international financial markets. In other words, it is clear that developments in financial markets have contributed to a more efficient allocation of capital. This is also to the benefit of pension funds. On the other hand, the integration of the financial markets and the technological developments have substantially increased the risk of contagion in the event of a financial crisis. It is necessary therefore for governments and authorities to continue to co-operate to create regulations and institutions for the purpose of minimising financial risk.

Thank you very much for your kind attention.