Guy Quaden: The integration of the euro government bond market – standstill or restart?

Keynote address by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Third Annual European Government Bond Summit, Brussels, 24 October 2008.

*   *   *

Ladies and Gentlemen,

It is a great pleasure for me to be the guest speaker at this third annual European Government Bond Summit. Even in these turbulent times, I hope that you still enjoy your dinner and will have time to attend the conference tomorrow. Its programme looks very interesting indeed, and closely reflects the current difficulties in the financial markets.

The primary dealers community is now, maybe more than ever before, of great interest for central bankers. Indeed, one of your main missions is to make sure there is enough liquidity in the government bonds secondary market. Proper functioning of this market is crucial to ensure liquidity for financial institutions, via the collateralised interbank market among others. And this market has become increasingly important since liquidity in the unsecured interbank market has been drying up. Owing to the high distrust among market participants, banks are still facing acute borrowing restrictions. This lack of market liquidity is one of the main problems with which central bankers are confronted at the moment. The Eurosystem has adjusted its distribution of liquidity – and will continue to adjust it for as long as necessary – to ensure that solvent banks have continued access to liquidity and to keep the very-short-term rates, in particular the overnight rate, as close as possible to the policy rate. The Eurosystem has assumed an increasing intermediation role during this period of turbulence. With its actions and the guarantees offered by individual governments, conditions are in place for a pickup in confidence and a gradual reduction in tensions on the money market.

Since the beginning of the financial turmoil in the summer of last year, the ECB Governing Council has made a clear distinction between liquidity management and its monetary policy stance, which is signalled by the interest rate on the main refinancing operations. The dramatic worsening of the financial crisis since the collapse of Lehman Brothers radically modified the outlook for growth and, as a consequence of lower commodity prices and faltering domestic activity, our assessment of risks to price stability as well. Therefore, the coordinated interest rate cut of 50 bp on 8 October was appropriate for the euro area. The Governing Council has thus shown that, without prejudice to its main objective of guaranteeing price stability in the medium term. it can also use its interest rate policy to help alleviate financial tensions and sustain confidence and economic activity.

Also from a monetary policy viewpoint, a properly-functioning secondary government bond market is very important. Allowing for the existence of a "risk-free" yield curve, it plays a crucial role in the transmission of monetary policy. Indeed, while the Eurosystem has only a direct influence on very-short-term money market rates, households and firms look mainly at medium- and longer-term rates when taking consumption and investment decisions. Consequently, when the Governing Council of the ECB reacts to disturbing shocks in order to maintain price stability in a medium-term perspective, it is interested in seeing monetary policy impulses effectively transmitted along the yield curve. Moreover, the Eurosystem's monetary policy strategy aims at firmly anchoring inflation expectations and minimising the inflation risk component of long-term interest rates. In this respect, government bond markets provide useful information on inflation expectations. Through their pricing of long-term government bonds, primary dealers thus contribute to the efficiency of monetary policy. Of course, we are well aware that the whole transmission process is now impaired by the banking crisis and we have to counteract these disturbances.

Last but not least, I am very pleased that the organiser of this summit, the European Primary Dealers Association, sees promoting integration of the EU government bond markets as its mission. Your association is therefore an active agent of financial integration. I would like to devote the rest of my speech to this issue. Firstly, I will remind you that the Eurosystem, too, has a strong interest in promoting such integration. Secondly, I will give a short overview of the current state of financial integration in the euro area, focusing on the government bond market. Thirdly, I will discuss several initiatives recently taken by the Eurosystem to foster financial integration, with special emphasis on the second generation of the Eurosystem's collateral management system, the so called CCBM2.

Apart from its particular importance for the conduct of monetary policy, financial integration is highly relevant to other Eurosystem tasks. It is fundamental to the Eurosystem's job of promoting the smooth operation of payment systems, which in turn relates to its great interest in the safe and effective functioning of securities clearing and settlement systems.

Furthermore, by permitting risk-sharing and diversification, by enhancing depth and liquidity of financial markets, integration also contributes to safeguarding financial stability. We are nevertheless aware that spill-over effects and contagion increase with financial integration. So, it will probably be a major challenge in the coming years to accurately gauge this dimension, as borne out by the growing importance of cross-border financial institutions. In recent weeks, when the financial turbulence was at its fiercest, it became clear that a revamp of prudential supervision in Europe will be an essential element of the reforms necessary to avoid a repetition of such a dramatic turmoil.

Finally, by encouraging more efficient allocation of resources, financial integration acts as a prerequisite for realising Europe's full economic potential, that is raising the potential for stronger non-inflationary economic growth, as highlighted in the Lisbon Strategy.

For all these reasons, the Eurosystem has always been a strong supporter of the European financial integration process and we have monitored developments in the different segments very closely. The tenth anniversary of the ECB, a few months ago, gave us the opportunity to take stock of the achievements in European financial integration over the last decade. We were proud to conclude that significant progress has been made and that the single currency has acted as a major driving force.

The progress that has been achieved nevertheless differs across market segments. The money market, in particular the interbank market for unsecured deposits, can be considered as a single area-wide market – also its current difficulties ignore national borders! But the segment for short-term debt securities (commercial paper and certificates of deposit) is still fragmented. I would like to remind you that, in order to try and close this gap, the Eurosystem is supporting the private STEP initiative which aims to develop a pan-European short-term paper market.

A considerable degree of integration has also been achieved in corporate bond and equity markets. By contrast, while the euro-area banking markets for wholesale and capital-market-related activities also show clear signs of integration, retail banking markets have so far remained fragmented.

Undoubtedly, the euro-area government bond market is the segment – apart from the unsecured money market – that has reached the highest degree of integration. The removal of exchange rate risks, the drop in transaction costs and the disappearance of currency restrictions for investors and intermediaries have pushed up cross-border bond holdings. Let me mention the case of my own country. At the end of June this year, the proportion of Belgian linear bonds held by foreigners reached 55 p.c. In the case of Treasury certificates, foreign holdership came to 73 p.c. at the same moment in time, which reflects the strong foreign demand generated by the relative scarcity of short-term euro-denominated public securities which were accorded a good rating by the credit rating agencies.

The primary dealer community, which has become more and more diversified, has been highly supportive of these developments. Looking for instance at the situation in this country, only 3 of the 16 primary dealers active on the Belgian government securities market, are actually Belgian! Financial institutions active in the main financial centres of the world (New York, London, Paris, Frankfurt) are now contributing to a successful widening of the investor base for securities issued by the Belgian Treasury.

Besides growing market integration, the long-term tendency towards more sustainable public finances, across all member states, has also helped achieve close convergence of government bond yields among EMU countries. For many euro-area nations, government bond yield spreads vis-à-vis the German Bund declined from the introduction of the euro until mid-2007, when they were just a few basis points.

While government bond yields are increasingly driven by a common factor, local factors continue to play a role, however. The financial crisis we are going through has shed some light on the remaining gaps in the euro-area bond markets. Strong flight-to-quality flows have been accompanied by a sharp widening of intra-euro-area government bond yield spreads. In the euro area, the ten-year sovereign spreads vis-à-vis the German benchmark have reached levels not seen since the start of EMU (this morning: Italy 88 bp, Spain 56 bp, Belgium 53 bp, France 26 bp). A common shock – namely, the sharp increase in risk aversion in global markets – thus led to different responses in the government bond market.

The underlying factors behind this increase in bond yield spreads are multiple. The German Bund certainly benefited from its high liquidity – favoured by a highly-performing futures market – a strong plus in these turbulent times. Credit risks were also a factor – although not the main one – behind the increase in bond yield spreads, as corresponding credit default swap spreads also widened. Here in Belgium, the long drawn out discussions about the country's institutional future have long hampered the formation of a stable government. All this uncertainty has taken its toll on the financial markets; the credit default swap rate for Belgium increased somewhat, compared with Germany's rate. These increases have been quite modest, though, which seems to indicate that the markets believe – as I do – that these difficulties could be solved without far-reaching financial consequences. More recently, the problems confronting some of our main financial institutions have also had some influence. The Belgian government – like several other European governments – had to recapitalise those institutions, which pushed up the outstanding public debt, and thus also the credit default swap rate for Belgium, which is now some 26 basis points higher than for Germany.

Anyway, as I said before, the increase in spreads vis-à-vis the German Bund is a general phenomenon. One may fear that the recent financial turbulence will lead to a standstill or even a setback for European government bond market integration. So it might be useful to consider some initiatives to relaunch this integration process. Here, we can refer to several reports written by the Giovannini Group.

In a report presented in 2000, this Group addressed the issue of "Co-ordinated public debt issuance in the euro area", arguing that the decentralised approach to public debt issuance was an obstacle to full market integration. Different options for greater co-ordination were discussed, including the creation of a single euro-area debt instrument backed by joint guarantees, an option that could be beneficial for smaller member states, currently paying liquidity premiums. Unfortunately, the Group did not start any concrete specification of such options. I nevertheless notice that tomorrow you will be bringing up the subject of common issuance again. Maybe your summit will give new impetus to this idea.

In two later reports (2001 and 2003), the Giovannini Group focused on clearing and settlement infrastructures in the EU. It described clearing and settlement as an essential feature of a smoothly functioning securities market, providing for the efficient and safe transfer of ownership from the seller to the buyer. It identified a number of barriers to efficient cross-border clearing and settlement.

Since the start of EMU, the ECB has taken a good many initiatives to provide payment and settlement facilities that foster market infrastructure integration and ensure the highest standards of efficiency and safety.

First of all, I would like to mention TARGET, the real-time gross settlement system for the euro, which, since its launch in January 1999, has contributed to the integration of euro-area financial markets, by providing its users with an area-wide payment infrastructure. In response to the growing demand from financial institutions for more advanced and harmonised payment and settlement services across Europe, the Eurosystem decided to migrate from TARGET as a system of systems, to a single shared platform, TARGET2, where the rules of the different legal systems are harmonised to the greatest possible extent.

Let me now say a few words on the second of these ECB initiatives: the so-called CCBM (Correspondent Central Banking Model). As you know, all Eurosystem credit operations have to be adequately collateralised by eligible assets. Moreover, the Eurosystem's operational framework stipulates that counterparties can only obtain credit from the national central bank in the country in which they are located, and that any Eurosystem counterparty should be able to use any eligible asset as collateral. Thus, a specific mechanism had to be established to enable the cross-border use of collateral, regardless of the location of the asset or the counterparty.

Against this background, the Eurosystem introduced the CCBM in 1999 in parallel with TARGET. Through the CCBM, counterparties obtain credit from their "home central bank" based on collateral provided to another Eurosystem central bank and this "correspondent central bank" holds the collateral on behalf of the home central bank. In the current framework for the delivery of collateral, the CCBM provides for a common cross-border procedure, while national collateral delivery procedures are still not harmonised.

The CCBM has proved to be a success, as the cross-border use of collateral has increased significantly. However, market participants have found some drawbacks in this system which mainly relate to the lack of standardisation of existing procedures, both domestically and at cross-border level. Against this background, the Governing Council decided in March 2007 to review the current Eurosystem collateral handling procedures. In July 2008, it has decided to launch a single technical platform – called CCBM2 – and assigned the development and operation of CCBM2 to the National Bank of Belgium and De Nederlandsche Bank.

CCBM2 will first and foremost provide a harmonised level of service, thus facilitating interaction between the Eurosystem central banks and their counterparties. While the CCBM was built for the cross-border use of collateral only, CCBM2 will provide a single set of uniform procedures both on a domestic and a cross-border basis.

CCBM2 will handle all eligible collateral, marketable as well non marketable. It will consequently allow to manage securities but also incorporate functions for the use of credit claims as collateral. Furthermore, CCBM2 will support the two currently used collateralisation techniques (pledge/pooling and repo/earmarking) and will be able to accept collateral through all eligible Securities Settlement Systems.

While CCBM2 is first and foremost a collateral management facility for the Eurosystem (a "Eurosystem back office"), it will at the same time bring new opportunities for Eurosystem counterparties to reduce back-office complexity and cost and optimise their collateral and liquidity management with the Eurosystem. By harmonising procedures related to the Eurosystem credit and collateral management, it will also create a level playing field. In order to ensure that CCBM2 is fully in line with counterparties' needs, the Eurosystem is developing this new facility in close cooperation with market participants themselves.

If we look to the future, CCBM2 will also be implemented in a way that changes in the collateral framework, such as the acceptance of new asset types or the introduction of risk control measures, can easily be taken up. As you know, the acceptance of a wide range of assets eligible as collateral is a structural feature of the Eurosystem's operational framework.

Nevertheless, last week, the ECB Governing Council decided to extend it further until the end of 2009, to make sure that solvent banks can get the liquidity they need. This temporary measure is liable to increase the risks taken by the Eurosystem in its refinancing operations. Adequate risk control measures will be applied in order to limit those risks.

Finally, as a third initiative aimed at better market infrastructure integration, the Governing Council decided, back in July, to launch the TARGET2 Securities (T2S) project. T2S will be a technical platform for central securities depositories for the settlement of euro securities in central bank money, thereby bringing together securities and cash settlements within Europe on one efficient single platform. On a more technical level, T2S will remove the differences between conducting domestic and cross-border settlements within Europe and will act as a catalyst for the integration of the European post-trading financial sector. It will also foster competition and harmonisation in post-trading by providing equal and less costly access to a common settlement service. Through the single platform, economies of scale can be fully exploited, while at the same time the safe and smooth settlement of securities transactions in central bank money is ensured.

Subject to certain conditions, almost all euro-area central securities depositories, accounting for a very large share of settlement activity in the euro zone, have reacted very positively to the initiative. For the further development of T2S, the Eurosystem will continue to cooperate closely and transparently with these depositories, their users and other relevant stakeholders.

Once implemented, the three so called "second-generation" services, TARGET2, CCBM2 and T2S, will represent a quantum leap forward in the integration and quality of the euro area's core infrastructure. These initiatives enhance the harmonisation efforts through the removal of Giovannini barriers, thus reinforcing the Lisbon Strategy.

I am sure that market participants – and especially the primary dealers – will recognise the opportunities these Eurosystem initiatives present so that we can work together for truly integrated euro financial markets, capable of withstanding turbulence in future.

Ladies and Gentlemen, thank you for your attention and I wish you a pleasant and very interesting meeting tomorrow.