Mr Duisenberg discusses the role of capital markets and financing in the euro area

Speech by Willem F Duisenberg, President of the European Central Bank, at the Waarborgfonds Sociale Woningbouw in Utrecht, the Netherlands, on 14 June 1999.

Introduction

The European capital markets have gone through a major structural change with the introduction of the euro. Eleven national markets have received a strong impetus to integrate into a single euro area capital market. In addition, the process of integration seems to go beyond the euro area, with links being forged with other European markets.

Capital markets represent a fundamental element of the financial system of any modern economy and they play an important role in the allocation of capital within the economy. Therefore public authorities responsible for economic policy as well as private sector agents who are active in the capital markets have a vested interest in capital markets that are both efficient and stable.

Today, I would first like to discuss the role of the capital markets and the advantages of possessing deep and liquid capital markets. Secondly, I will turn my attention to the effects on capital markets that we have already seen since the introduction of the euro, and the process of further integration in capital markets that is expected to continue in the future. The emphasis of this discussion will be on the euro area bond markets. Thirdly, I will focus my attention on the important issue of how these developments which are expected to take place are likely to shape financing in the European capital markets and in particular how they might affect financing through the euro area bond markets. Finally, I will turn my attention to the role that public authorities have already played and will play in this process in the future.

The role of efficient and stable capital markets

Turning first to the role of capital markets, it might be asked why one should be interested in the depth and liquidity of capital markets at all. After all, capital markets are mostly in the business of trading in bonds and equities that have been issued in the past. The actual financing or allocation of new capital represents only a fraction of the daily turnover of capital markets.

Indeed, from the point of view of allocating capital across productive purposes the secondary market is not of direct relevance. And as you know, in most financial systems there has been a phase in which markets have been more or less non-existent and financing has taken place through intermediaries, banks.

However, deep and liquid secondary markets play a very important indirect role for financing in capital markets. First of all, well functioning secondary markets provide transparent market prices for capital market financing. Those economic agents involved in planning physical investments know at all times what the cost of capital is, and can take this into account in their investment decisions. Furthermore, savers know at all times what yield they can earn from various instruments. In addition, the existence of an active and deep secondary market ensures that savers and borrowers can be relatively confident that their decisions will not have significant effects on market prices.

For those that provide financing through capital markets, the existence of a liquid secondary market provides the means to adjust portfolios without incurring large costs. In these circumstances investors will tend to reduce the rate of return that they demand. This clearly means that the liquidity of the capital market is a key consideration for the efficiency of allocation of capital.

In short, depth and liquidity are key ingredients for capital markets that function in an efficient and stable manner, and these necessary elements can only be achieved through active secondary markets.

This background should have convinced you that I see great merit in the existence of deep and liquid capital markets alongside a stable and efficient banking sector. This is not for the markets themselves, but for the important role they play in the allocation of capital and indeed for investments and growth in the economy.

The introduction of the euro and the European capital markets

The introduction of the euro has already affected and is likely to affect the euro area financial markets in a profound manner in the future. A good example of this influence is provided by developments in the euro area money markets since the beginning of this year. Following the changeover to the euro, a highly competitive single money market has already emerged in the euro area as banks were well prepared for the changeover to the euro and the TARGET system has provided an efficient means of making cross-border payments. In particular, differences in overnight interest rate spreads now mainly reflect differences in the credit standing of banks rather than that of the country in which money market transactions occur. So, in the course of a very short period of time, the original eleven mechanisms to allocate and price short-term financing within the respective banking sectors of participating countries were transformed into a single mechanism for the entire euro area.

Concerning longer-term financing, we have good reasons to believe that a similar evolution towards a single market is already well under way. With the integration of the markets, what I mean is that market prices of the euro area will increasingly provide an accurate reflection of differences in quality between various issuers as well as differences in liquidity between securities. Furthermore, divergences purely related to the location of market participants within the euro area will have to become less and less relevant over time.

It is important to remember that the capital markets of the euro area began the process of integration well before the start of Stage Three of Economic and Monetary Union. An indication of the pace of integration before January 1999 is provided in particular by the evolution of spreads between yields on bonds issued by the various central governments of the euro area, which narrowed continuously from mid-1995 onwards. The factors that contributed to this favourable pattern included increased convergence towards low rates of inflation across the euro area during Stage Two, the gradual reduction and finally the elimination of exchange rate risks, the commitment of governments towards improving the sustainability of public finances. A further factor was the improvement of the depth and liquidity of government bond markets themselves.

The integration of the euro area central government bond market is therefore well under way. Differences in bond yields should be reflective of differences in creditworthiness of debtors, and even more so of the liquidity of a given bond. This liquidity effect is visible in the term structure of yields across the euro area, as the lowest yields at different points on the maturity spectrum have been seen on bonds that have been issued by different countries in the euro area that have had different credit ratings.

Turning to equity markets, a similar process of integration is apparent. With regard to the behaviour of investors, an increasing number of equity market participants already appear to be taking investment positions on the equity market of the euro area from a sectoral rather than a national perspective. Reflecting this development, various market participants have made both area-wide and sectoral equity indices available, thus providing investors with opportunities to monitor area-wide equity investment positions.

Furthermore the institutional set-up of stock exchanges is showing signs of an evolution towards more integration and greater market efficiency. As consolidation within the financial services sector has increased the size and geographical reach of intermediaries and fund management institutions, they and also some listed companies seem to be pressing for market-places to become more concentrated in order both to reduce costs and to enhance liquidity.

Financing in the euro area capital markets

The euro area bond market is the second largest market in the world after the US market. However, the euro area market is not yet as integrated as the US market, implying that some of the benefits of a large market have yet to be realised.

Looking at financing in the European bond market, two groups of debtors account for the large majority of the outstanding stock of debt securities, namely public sector and financial institutions.

The amount of outstanding public sector bonds in the euro area is more than 3 trillion euros, somewhat less than 60% of euro area GDP. While that amount provides the market with depth and liquidity, you will not be surprised to hear that I would like to see this ratio to GDP coming down. The amount of public debt in the euro area is still too high. For a stable euro it is also – though not solely – of vital importance that governments should keep their commitment to reduce their indebtedness to more sustainable levels as agreed in the Stability and Growth Pact. This would support monetary policy, create room in government budgets to accommodate periods of unfavourable economic developments and make it possible to bear the burden on the budget resulting from the imminent ageing of the population. Reduced borrowing by the public sector would also leave more room for the private sector to issue debt securities.

In terms of issuance of bonds, the euro area financial sector ranks second to the public sector in euro area capital markets. And indeed, longer-term debt financing by the corporate sector in Europe still takes place predominantly via financial intermediaries, which partly fund themselves through capital markets. For this part, the European capital markets do not allocate capital directly between savers and investors, but rather through intermediaries. In the United States, where there is a very active corporate bond market, the situation is quite different, with bank loans only forming a major source of financing for small and medium sized companies.

There are a number of reasons why corporate sector financing in the euro area capital markets is likely to benefit from integrated markets in the future.

Firstly, as I mentioned earlier, the depth and liquidity of capital markets are important for capital markets to perform their functions efficiently. With integrated markets we will see deeper and more liquid markets than was the case beforehand in any of the euro area countries. Private sector issuers in general and companies in particular are by definition heterogeneous and the development of an efficient market for corporate bonds for various types of companies and within various maturity ranges requires the existence of a large market. In order to guarantee a competitive market price for a given corporate bond, it is necessary for there to be a large number of bonds which share similar characteristics in the market.

Secondly, for large companies in particular, it makes sense from the point of view of efficiency to have all the various means of financing at their disposal, namely bond and paper financing as well as bank loans and equity financing. Indeed, the credit ratings of many large companies in the euro area are better than the credit ratings of most banks. This should lead to savings on the cost of capital for the most creditworthy companies, if they were to be more active in bond issuance.

Thirdly, it is important to note that in a number of countries, the debt securities market for longer-term maturities in their own currency was close to non-existent in the past. For example, 20 or 30 year debt issuance was available only in some currencies, at least with a fixed interest rate. These types of debt securities are now available across the euro area.

Fourthly, an increase in global demand for euro-denominated debt securities can be expected, as the euro becomes an even more important reserve currency than it already is. Moreover, the demand for higher risk euro-denominated debt securities is likely to increase, particularly as the current low level of sovereign yields increases incentives to search for higher yields.

A factor that is not related to the integrated market but is nonetheless important for the future evolution of the capital markets is the pattern of demographic trends in most euro area countries. The euro area population is ageing, and this means that we have to save in order to be able to take care of future pension payments. In the Netherlands this is already done, traditionally, on a larger scale than in some other euro area countries. Part of these savings will be invested in capital markets. Furthermore, with ageing, we have also seen an increase in the wealth of individuals, and this wealth is being invested more and more in financial assets rather than in real assets.

I have now listed a number of factors that suggest that activity in the euro area as well as European capital markets more generally will increase in the future. And indeed, since the introduction of the euro, corporate bond issuance seems already to have gathered pace. During the first quarter of this year, the amount of new issues was high compared with previous years. According to some sources it was nearly on par with the full year of 1998 and it was considerably more than in 1997. There may have been some exceptional factors that could have accounted for part of this development. For example some companies may have timed their bond issuance to benefit from the expected increased interest in euro-denominated securities at the beginning of the year. Nonetheless, it seems rather likely that an upward trend in corporate bond issuance has commenced in the euro area.

Public authorities and efficient and stable capital markets in Europe

I touched upon the fact earlier that public authorities also see merit in having efficient and stable capital markets in the euro area and in Europe generally. In order to contribute to a favourable development, authorities have been and are active in a number of fields. I will first mention something about the activities of other authorities and then I will conclude my presentation today with some remarks on how we in the Eurosystem are contributing to a favourable development in this field. When I say Eurosystem, I am referring to the European Central Bank and the eleven national central banks of the countries which have adopted the euro.

A prudent, harmonised regulatory framework, on the one hand, and harmonised market practices, on the other, are key factors in guaranteeing the smooth integration and development of European capital markets. In these areas a lot of work has already been conducted, and a lot more has still to be achieved in order to pave the way for truly integrated financial markets. Harmonisation in repurchase agreements, national company laws including bankruptcy laws, and other aspects of the legal and regulatory framework, for example, would enhance legal clarity and certainty and thereby improve the efficiency and stability of the financial markets.

At this point, I would like to draw your attention to the Action Plan recently published by the European Commission. It contains priorities and timetables for measures aimed at improving the functioning of the single market for financial services. In particular, measures are proposed to advance the harmonisation of the legal framework and market information, as well as to facilitate investors' operations throughout the single market.

Finally, what is the role of the Eurosystem in this whole process? I could first mention the "market-friendly" operational framework of the Eurosystem, which facilitates the efficient functioning of capital markets, for example, by being very transparent and accepting a wide list of securities as collateral.

Moreover, capital markets trade in long-term commitments, be they equities or bonds. When pricing these long-term commitments, investors face many uncertainties, not only concerning the issuer but also the future economic environment. The latter uncertainties are reduced by the Eurosystem's clear commitment to its primary objective, price stability.

Looking at the current situation in euro area capital markets, we can see that market participants consider this commitment by the Eurosystem to be credible. Yields on long-term government bonds are at relatively low levels. These low levels reflect a high degree of confidence in the ability of the Eurosystem to maintain price stability in the euro area over the longer term. In other words, both inflation expectations and the risk premia associated with inflation uncertainty are low at present, a situation that we wish to maintain.

For the bond markets and therefore for companies financing themselves in the market, the high level of credibility attached to the Eurosystem is highly beneficial. In particular, the fact that inflation risk premia are low means that companies as well as housing associations seeking long-term financing do not have to pay for the risk that the central bank may not be able to maintain price stability over the longer term.

For the economy as a whole, this environment of low costs of long-term financing should be conducive for the private sector to undertake productive investments. Companies can also take advantage of the longer planning horizon provided by the knowledge that the cost of capital they employ in their investments will remain stable. I do not have to tell you that this is also of fundamental importance in your sector, i.e. housing.

For the last minutes I have focused on the developments in the European financial markets in general rather than what these developments specifically mean for you. I wanted to outline to you the European environment in which you will increasingly be operating. In Europe, we are unquestionably moving towards integrated financial markets. Clearly, this will have an impact on the financing of housing as well. I have mainly described general consequences and will leave it to you to draw your own conclusions about how this will affect the financing of housing associations.