



Financial markets and the funding of enterprises in the European Union: what future?

Scenarios

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Executive summary

This report explores the future landscape of the financial services industry with the help of three different scenarios. Of particular interest in these scenarios is the issue of whether the structure of business finance will shift towards greater reliance on capital markets, equity and bonds, and hence take reduced recourse to bank finance. In other words, the question addressed in the scenarios is the following: Is the structure of business finance in the European Union, especially in continental Europe, likely to converge towards the one observed in Anglo-Saxon economies? These are economies where financial intermediaries, banks in particular play a much smaller role in the allocation of savings to productive investment purposes.

A first building block of the scenarios is a review of the structure of business finance in Europe, where non-financial corporations in the euro-area rely significantly more on bank finance than their US counterparts. In contrast, they rely somewhat less on equity finance and substantially less on market debt finance (bonds, etc.). In recent years, during the booming stock market, corporations in the euro-area issued a large amount of new equity that accounted for the majority of funds raised by these corporations, but this phenomenon appears to have tapered off. Bank loans are a particularly important source of business finance in the major economies of continental Europe such as France, Germany, Italy, Spain and Sweden where loans account for 57% and more of the businesses' liabilities. The importance of loans in business finance varies somewhat among the smaller EU economies, but is in all cases a relatively important source of funds.

Furthermore, the report looks at the key factors that drove change in financial markets in the nineties. Among the many factors that had some influence, the following nine key drivers are identified and discussed in greater detail:

- the information and communications revolution;
- globalisation;
- the European single market for financial services and the euro;
- monetary and fiscal policies in Europe;
- privatisation;
- an increased willingness by households to take risks;
- the growing importance of non-financial intermediaries;
- venture capital;
- restructuring and consolidation in the financial sector.

After reviewing how each of these factors influenced financial markets in the nineties, the study examines whether they are likely to continue to remain a significant driver of change in the years ahead. The assessment is that, depending on the circumstances, all, with the exception of privatisation, are likely to remain important agents of change in the coming years.

The next focus is on today's new pressure points that may impact on the shape of financial markets. These are the uncertain economic outlook, the distrust in large companies and a general disillusionment with stock markets, corporate governance and corporate social responsibility. It seems that these new factors will also be significant drivers of change in financial markets in the years ahead.

Finally, the report discusses the implications of two factors, namely pension reform and implementation of the new capital requirements (the New Basel Capital Accord – Basel II), that will only start to impact on financial services providers in the future.

To simplify the analysis, the scenarios present a number of future drivers of change which will have an identical impact in each case. These are the continued impact of:

- the information and communications revolution;
- monetary policy;
- the completion of the single market in financial services;
- globalisation;
- the absence of significant financial and banking crises, as well as a continued process of consolidation and restructuring in the financial sector;
- the drive towards a better governance of corporations and financial institutions;
- the implementation of corporate social responsibility principles.

Among the key factors that vary across the scenarios are the pace of economic recovery, the evolution of stock markets and households' trust in equity investments. The future course of fiscal policy, the role of non-bank financial intermediaries and venture capital are also critical elements in the scenarios, as well as the expected pension reform and the implementation of Basel II.

All three scenarios come to the conclusion that bank loans will remain the most important source of funds for business in continental Europe over the coming years.

In the first scenario, equity financing may regain some of its lost shine, while, in the second scenario, bond finance may finally become a more important source of funds for businesses in Europe. In the last and more pessimistic scenario, one would expect bank finance to gain in importance in the future.

Overall, it appears unlikely that expectations, formed during the recent stock market boom, of major change in the structure of business finance will be realised soon. Loans from banks and other financial intermediaries will remain an, if not the most, important source of business finance in most EU Member States. The very large contribution of new equity issues in new business financing of the late nineties is likely to have been only a temporary deviation from a well-established pattern.

Introduction

Financial markets have undergone profound and rapid changes in the past decade. Globalisation, liberalisation, the advent of the euro, improved macroeconomic policies, technological and institutional change have all been powerful drivers of change in financial markets. The exuberance of the late nineties has now given place to a more realistic, perhaps even overly pessimistic, view of financial markets, and the pendulum has swung back towards rewarding caution and prudence again. But, the consequences of many of the systemic changes of the past decade will continue to be felt over the coming years and new issues and pressure points will unavoidably arise.

For many enterprises, the second half of the nineties was a period of easy and cheap access to funds. In particular, a large number of firms, small and large alike, turned to stock markets to meet part of their financing needs, often for the first time in their life. However, now that stock markets have fallen dramatically from their peaks of 2001 and the cost of equity has increased again considerably, new equity issues have more or less dried up. At issue is whether this is only a temporary pause in the recent evolution of the financial landscape, or marks a more pronounced turning point in the general trend.

At this highly uncertain juncture, only a fool would be brave enough to pretend to know exactly how the shape and nature of financial markets might change over a medium-term horizon of five years and more. Yet, to be relevant and successful, public policy development and strategic business planning cannot avoid peering into the future. In cases of heightened uncertainty, scenario-based analysis is a useful instrument that helps to identify the key forces that may shape the future and highlights how different combinations of these forces may result in different outcomes.

This report presents three scenarios about the possible future developments of financial markets. Peering into the crystal ball to predict future trends is always a perilous exercise, especially if the projection horizon is longer than a few years, and the danger of being wrong is very real. The scenarios presented in this report are not precise forecasts of future market developments, but they put forward plausible and coherent descriptions of how financial markets might evolve under certain circumstances. The future trajectory of many conditioning factors is very unclear at the present time and the scenarios should be seen as a roadmap of how different factors may affect future financial markets and the structure of business finance in Europe.

However, before looking ahead to the future, it is necessary to take stock of the conditions at the starting point. This is what the report does in the next three chapters. In the first chapter, the report provides an overview of the present structure of business financing in Europe and how it has evolved in the recent past. The second chapter identifies the key main drivers of change in financial markets that were at play in the nineties. The third chapter draws together conclusions of the retrospective. The fourth chapter briefly addresses today's core issues and the challenges faced by financial markets, and identifies a number of new issues that are likely to affect financial markets in the future. Finally, the last two chapters of the report present the three different scenarios.

¹ Scenarios are strategic planning tools that are commonly used by businesses and governments nowadays. See for example Shell International 2002.

The structure of business financing in Europe

So far, only a limited number of studies have focused on the structure of business financing in Europe and how it differs within Europe and from that observed in the US. This chapter begins with a comparison of the financing structures of non-financial businesses in the euro area. It then presents the most recent trends and finally addresses the issue of potential differences within the European Union and recent changes in these differences.

International comparison of non-financial businesses financing structures

Three facts emerge from the most up-to-date international comparison by the European Central Bank (ECB) of financing structures of non-financial corporations (see Table 1).

Euro area non-financial companies rely much more on loan financing than US companies. Loans accounted for 23.3% of total liabilities of non-financial eurozone companies while the share of loans in total liabilities stood at only 5.4% in the US.

In contrast, US companies depend much more on debt market instruments for their funding than do European companies. In 1999, securities other than shares accounted for 10.6% per cent of all liabilities of US non-financial companies while, in the euro area, this figure was only 2.4%.

Finally, equity financing is somewhat less important in the eurozone than in the US, but the differences are less pronounced than in the case of debt financing.

Some of the differences in financing structures narrowed substantially through the second half of the nineties with the share of loan financing falling and the share of equity financing rising in Europe. Bank loans and equity finance appear to have been strong substitutes in the euro-area while little change is observed in the share of debt securities.

Table 1: *Financing structure of non-financial businesses (at the end of the year, in percentage of total liabilities)*

	Euro area			US
Liabilities	1997	1998	1999	1999
Loans	30.0	27.2	23.3	5.4
Trade Credit and advance payments received	10.7	9.8	8.3	7.8
Securities other than shares (i.e., bonds, etc.)	3.1	2.8	2.4	10.6
Shares and other equity	51.7	56.3	62.6	70.2
of which quoted shares	19.6	22.0	26.3	-
Other liabilities	4.5	3.9	3.3	6.1

Source: *European Central Bank*

Trends in the financing of non-financial businesses in the euro area

Looking at how non-financial corporations met their funding needs in recent years, the sharp rise in the share of equity issues in total funds raised in 1999 and 2000 stands out (see Table 2). In 2000, at the peak of the stock market boom, new equity share issues accounted for 70% of all new funds raised by non-financial corporations. This figure had already dropped back to 60% in 2001 and is likely to have since fallen much more in 2002. A key issue in looking ahead to the future is whether this drop is only temporary or marks a return to the more traditional continental European pattern of corporate financing with greater reliance on loans from financial intermediaries.

Table 2: *Funds raised by non-financial corporations in the eurozone (in percentage of total funds raised)*

	Loans	Securities other than shares	Quoted shares	Other
1998	44.6	5.8	42.2	3.6
1999	41.9	5.4	68.6	5.1
2000	39.1	5.0	70.1	4.2
2001	45.7	6.5	59.4	4.5

Source: *London Economics calculations using ECB data*

Differences in the financing structures of European non-financial businesses

Little comprehensive information exists on the structure of corporate finance in Europe. The early literature on this issue aimed to test the hypothesis that companies in capital market-dominated financial systems (such as the US and the UK system) will use equity rather than bank loans in order to finance their business, in contrast to companies in bank-dominated systems (Schmidt and Tyrell, 1997).

Numerous studies (Antoniou, Guney and Paudyal, 2002; Borio, 1990; European Committee of Central Balance Sheet Offices Own Funds Working Group, 2000; Hackethal and Schmidt, 2000; Nayman, 1966; Rutterford, 1988; Wanzenried, 2002) find evidence for this view in cross-country comparisons of corporate capital structure. However, some studies (Mayer 1990; Edwards and Fischer, 1994), employing a flow of funds approach, found very little differences in the financing of companies across countries. The only significant difference they found is that internal financing is more important in capital market-dominated countries than in countries with bank-dominated financial systems.

The view that cross-country differences are not substantial has since been supported by further studies of corporate capital structure. These studies (Deutsche Bundesbank, 1994; Rajan and Zingales, 1995) attribute the cross-country differences found in other studies to the fact that differences in accounting standards have been neglected.

More recent studies (Coeurderoy, 2001; Friderichs and Paraque, 2001; Rivaud-Danset, Dubocage and Salais, 2001) argue that the answer to the question of whether corporate capital structures differ across countries or not, depends on the size of the companies in question. They find that capital structure differs significantly for companies of different sizes. Although there seem to be no significant cross-country differences in the financing of large companies, evidence has been found which supports the view that there are huge cross-country differences in the capital structure of small companies. In particular, it has been shown that bank loans are a much more important source of financing for small companies in Germany than in other countries.

A second conclusion of the most recent literature is that significant differences exist in capital structure between equity-issuing companies and non-equity-issuing companies (Ramb, 2000).

The main conclusion that can be drawn from this brief overview of the literature is that the issue of potentially different business capital structures across Europe is still largely unresolved, largely because of a lack of consistent data across the European Union. Nevertheless, as the focus of this study is on the potential impact of future financial market developments, it is useful to briefly review the data that is currently available (Table 3). In the absence of comprehensive data sources on the structure of corporate financing in Europe, the analysis is based on a combination of the most recent information available from either the European Commission Bach databank or the OECD *Financial statements of non-financial enterprises* (1999). Some of the data may not reflect the most recent developments, but, nevertheless, does provide a reasonable picture of the main differences across Europe.

It is important to note that the data in the column 'bank financing' includes not only short- and long-term bank loans but also all other financing sources whose cost will generally move in line with bank rates such as trade financing, loans by non-bank financial intermediaries, etc.

The three key points to note are:

1. the small share of bond financing in all EU Member States but France;
2. the large variation in the share of equity in total business financing, ranging from a high of almost 55% in the UK to a low of just over 30% in France, Germany, Italy;
3. the corresponding variation in reliance on banks financing and other non-market debt financing (i.e. trade credits, etc).

Table 3: *Structure of the liabilities of European non-financial businesses*

Country	Source	Percentage share of		
		Equity	Bonds	Bank loans
Austria	OECD	48.5	5.5	46.0
Belgium	OECD	42.8	1.7	55.5
Denmark	OECD	46.5	2.0	51.5
Finland	EC-Bach	46.2	2.5	51.3
France	EC-Bach	32.1	7.9	60.0
Germany	EC-Bach	32.3	1.2	66.5
Greece	Not available	-	-	-
Italy	EC-Bach	32.2	0.9	66.8
Ireland	Not available	-	-	-
Luxembourg	Not available	-	-	-
Netherlands	OECD	45.6	3.5	50.9
Portugal	EC-Bach	49.2	3.2	47.6
Spain	EC-Bach	40.4	2.7	56.9
Sweden	OECD	39.4	2.0	58.6
United Kingdom	OECD	54.8	2.0	43.2

Sources: OECD (1999) and EC-Bach (Business accounts harmonised databank).

The Bach database covers only manufacturing industries.

The financing structure of non-financial businesses may have converged somewhat in the late nineties, but it is doubtful that the differences have narrowed substantially. Moreover, the recent falls in stock markets worldwide would suggest that, at least over the short run, new equity issues are unlikely to become the major source of business funding in many European countries in the immediate future. Obviously, the outlook for the medium term is much less certain. Any further shift towards greater reliance depends on the future course of stock markets.

More critical, however, than the issue of whether equity financing will become important or not is the question of whether this matters at all.

Does the difference in financing structure matter?

There is a general consensus in the economic literature that a well-functioning financial system is important to the well-being of an economy. Deeper and more developed financial systems are associated with stronger economic growth. (For a survey of the recent literature see, for example, Caretonni et al, 2001; Khan and Senhadji, 2000; Levine, 1997; Thiel, 2001 and Tsuru, 2000.)

However, there is considerably less consensus on whether a market-based financial system such as in the US and the UK yields a superior economic performance than a bank-based financial system such as in continental Europe. Tadesse (2001) finds that, across countries with well-developed financial systems, industries supported by market-based financial systems grow faster than industries with bank-based systems. The opposite is the case across countries with less developed systems. Moreover, the author finds that in countries dominated by small firms, bank-orientated financial systems support economic growth while market-orientated financial systems retard growth.

In contrast, Levine (2002) finds that there is no cross-country empirical support for either the market-based or bank-based views and neither is particularly effective at promoting growth. Caretonni et al (2001) in their survey of the literature on this topic reach a similar conclusion.

Thus, whatever future changes might occur in the structure of financial systems in Europe, it is difficult to conclude, on the basis of the present state of knowledge on the topic, that it would be preferable to move towards either one of the two basic models of financial architecture.

The second main building block of the prospective scenarios is the identification of the major factors that have driven financial markets in the nineties. This is the subject of the following chapter.

Key drivers of change in financial markets in the nineties

A large number of economic and social forces contributed to shape the economic landscape of the nineties and to produce one of the amazing decades in terms of economic stability, prosperity and increasing standards of living. In hindsight, it is obvious to everyone that the general feeling of a new era, limitless opportunities and abolition of standard economic laws was built on shaky foundations and that many 'bad' economic decisions were taken, especially in the latter part of the decade.

Yet, many of the systemic drivers that contributed to this so-called exuberance are still with us, though one tends to look at these with a greater degree of prudence, if not pessimism. Only future economic historians will be able to judge whether the pendulum has currently swung too far back. But, it is important to put these systemic drivers into a proper perspective as one looks forward into the future to draw a picture of how financial markets might look down the road.

The following sections highlight what can be considered as the main factors that helped to shape the financial landscape in the nineties. Each section starts with a backward-looking discussion of the impact of the specific factor and concludes with a forward-looking assessment of how the factor at hand may continue to be a driver of change in financial markets in the years ahead.

Information and communication technologies revolution

Looking back

Obviously, the most important catalyst of change in financial markets was the information and communications technologies (ICT) revolution. This had a profound effect on the organisation of financial institutions, their product delivery and the competitiveness of various types of financial market players. Moreover, it gave rise to a large stock market bubble in the nineties which is still being unwound at the present time and whose full economic effects may not yet have been fully felt.

The ICT gave birth to new players in the financial field that challenged existing practices and traditional players. Electronic equity trading systems aggressively pursued the business of established stock exchanges, forcing them to adapt and adopt new products, and deliver new services to survive. Electronic or Internet banking started to make inroads in the traditional retail banking sector.

Indeed significant cost advantages favour a large shift to electronic banking and financial intermediation. For example, the US Department of Commerce estimated in 1998 that the cost of a typical branch-based banking transaction was of the order of US \$ 1.07 while the cost of a similar transaction over the Internet was only US \$ 0.01. Technological advances since 1998 will likely have further reduced the costs of Internet-based transactions while there is little scope to further reduce the cost of a branch-based transaction.

Vastly superior, faster and lower cost financial data processing capacity essentially abolished the concept of time and delays in financial transactions. It allowed financial institutions to adopt ever more sophisticated investment and lending strategies² and, increasingly, to develop and deliver tailor-made products and services.

²

The demise of the hedge fund Long Term Capital Management (LCTM) in the fall of 1998 stands as a stern warning that increased sophistication of mathematical and financial modeling does not provide fool-proof guarantees against losses nor is it a 100% substitute for prudence.

The resulting increased competition among various financial institutions led to considerable pressures on financial institutions to control costs and increase efficiency, although these pressures temporarily eased in the late nineties. As will be seen below, this is one of the factors that drove many financial institutions to merge in the nineties in the search of economies of scale and scope and greater efficiency.

At the macroeconomic level, it is by now generally accepted that the ICT revolution boosted productivity growth and standards of living although the precise quantitative contribution is still a subject of much debate (see, for example, Jorgensen and Stiroh, 2000; Oliner and Sichel, 2000).

But, the ICT revolution also had a number of pernicious effects. Among many other factors, it may initially have contributed to increase investors' risk appetite and enticed them to invest their funds in new and different instruments. This, in itself, is a positive development, as a greater risk-taking economy should eventually experience more robust growth. However, a condition for this to be true is that risk is properly assessed and rewarded. Unfortunately, the ICT-driven stock market boom led many investors and financial institutions alike to either vastly underestimate or completely ignore the risks they were taking. Rapidly rising stock markets hid this fact for a while but, as the bubble burst, many are now facing substantial losses, which, unfortunately, may discourage them from investing again in risk-bearing securities. In addition, it is estimated that financial institutions are left with a portfolio of doubtful quality of about US \$ 1 trillion in loans to the telecommunications sector (*The Economist*, 2002).

Moreover, the availability of 'cheap' funds led to a major misallocation of physical capital in the economy of which the wasted investment in the telecommunications sector is the most glaring example. Together with the wealth loss arising from the sharp fall in equity prices, this over-investment in physical capital is a major source of the current economic downturn. At issue is how long the capital overhang will last.

Looking forward

The ICT revolution is here to stay. New ICT-related inventions and applications will undoubtedly be brought to market. In the case of financial intermediaries, the competitive pressures from electronic services delivery platforms will undoubtedly intensify, especially if the economic downturn is prolonged and pressures to cut costs intensify (Long, 2002). This may also give a further impetus to continued restructuring and consolidation within the financial sector. On the other hand, it may also give rise to new attractive investment opportunities that may appeal even to those who are currently deeply disenchanted with the performance of stock markets. It may also contribute to improve the functioning of markets (more information, greater transparency, etc) (D'Avolio et al, 2001). While this would be of obvious benefit to society at large, it may put pressures on those financial market players that benefited from a lack of full transparency.

Globalisation

Looking back

The volume of information, financial and non-financial, that the ICT revolution made available and allowed to be transmitted instantly around the globe greatly supported the trend towards increased globalisation.

But globalisation is a much deeper and more complex phenomenon. It reflects the impact of the interaction of a number of factors such as:

- i) national and international economic policies put in place in the late eighties and early nineties;
- ii) the rapid growth of transnational businesses and domestic internationally-orientated businesses;
- iii) and major technological advances in both communications and transportation.

The main focus of the on-going debate about globalisation is on its impact on the poorer populations across the world. However, in the context of the present study, it is important to note that globalisation has essentially been felt at the level of financial exchanges among industrialised countries.

According to the International Monetary Fund (IMF, 2002), financial integration among industrial countries increased sharply over the last two decades in relation to both the growth in trade openness in industrial countries and the increase in financial openness in developing countries. Industrial countries have increasingly exchanged financial assets among themselves (reflecting hedging and risk sharing). For example, in the case of industrial countries, the ratio of external finance to GDP jumped by 77.3 percentage points between 1981-85 and 1997-2001 while the ratio of total trade to GDP increased by only 3.9 percentage points.

Table 4: *Indicators of rising global integration*

	Change in the ratio to GDP from 1981-85 to 1997-2001 (in percentage points)	
	Trade ⁽¹⁾	External Finance ⁽²⁾
Industrial countries	3.9	77.3
Developing countries	15.4	19.9

⁽¹⁾ Sum of exports and imports of goods and services, divided by GDP

⁽²⁾ Sum of external assets and liabilities of foreign direct investment and portfolio investment, divided by GDP

Source: IMF (2002)

The implications of globalisation for the financial sector are quite clear. The trend reported in Table 4 implies that national financial markets have increasingly become integrated with each other and shocks in any of these markets are rapidly transmitted to others. One need only recall how the 1998 Russian financial crisis spread quickly, first to other emerging markets, and subsequently, as a result of the collapse of the hedge fund Long-Term Capital Management (LCTM), to credit markets of industrialised countries where the spread on funds to less than top-notch borrowers widened considerably for a while. More recently, the daily news of stock markets declining jointly all over the world provides a vivid illustration of the integration of financial markets.

This anecdotal evidence of increasing financial integration is corroborated by a large body of empirical studies (Ayuso and Blanco, 2001, Fratscher, 2001, Rouwenhorst, 1999 and Tsatsaronis, 1999). They find that either stock markets or individual sectors of stock markets tend to move internationally. The importance of the phenomenon of international financial integration is also underlined by the considerable efforts devoted by the international financial regulatory community to the strengthening of the international financial infrastructure.

Looking forward

What are the implications of globalisation for the future landscape in Europe? Two factors are worth noting here. These are, first, the strong competitive pressures arising from international competition in and across various segments of the financial industry and, second, the increased exposure to both systemic risk and internationally transmitted financial shocks.

So far, the report has focused on globalisation as well as on economic and financial integration worldwide. But an equally, if not more, important driver of change in the European Union was the push towards the single market in financial services and the advent of the euro. The next section reviews these aspects in greater detail.

European single market in financial services and the euro

Looking back

The drive towards a single European market in financial services that began in the early nineties gathered considerable momentum in the second part of the last decade with the adoption of the Financial Services Action Plan (FSAP) whose target date for the completion of a fully integrated financial market is 2005. Moreover, the work on securities and risk capital markets is to be completed earlier, in 2003.

This push towards a fully integrated European financial market was one of the factors contributing to the recent restructuring and rationalisation process in the European financial industry. Financial institutions had to prepare themselves for the unavoidable increase in competition within the European Union. The introduction of the euro in January 2002 and the associated elimination of exchange risk in cross-border activities within the euro-zone has provided a further push to the consolidation process.

EMU and the elimination of exchange rate risk also helped to bring the market for euro-denominated corporate bonds out of its infancy, opening the door to a new source of finance for many European businesses (ECB, 2001). That being said, the weight of corporate debt in the euro-denominated market is quite small, accounting for just 6.6% of total value of euro-denominated bonds outstanding as of 2001. While still small, this share shows a sharp upward trend in recent years, up from 5% at the end of 1998.

A comparison of the size (in value) of the euro-denominated bonds market with that of the US dollar-denominated market also highlights more generally the still relatively undeveloped nature of the euro-denominated bonds market. At the end of 2001, the total value of outstanding euro-denominated bonds stood at US \$ 7.1 trillion while the equivalent figure for US dollar-denominated bonds was US \$ 18.1 trillion. Despite the changes resulting from EMU, the dollar-denominated market continues to attract a larger volume of new issuance.

EMU and the new opportunities for investing anywhere in the euro-zone without exchange risks also added further pressures on stock markets to rationalise and become more competitive as the traditional barrier of entry provided by exchange risk had disappeared. The issue of stock market competition and rationalisation will be addressed more extensively below.

Looking forward

What lies ahead? According to many observers (see for example, Ibanez and Molyneux, 2002 and Belaish et al, 2001), the financial sector has not yet felt the full impact of EMU and the drive towards a single market in financial services. The adjustment process is far from completed and much rationalisation, restructuring, and merger and acquisitions are to be expected over the coming years.

Next, a number of other government policies are reviewed, that had a strong bearing on the evolution of financial markets in the nineties. These are the adoption of low inflation and low budget deficit policies, especially in the run up to European monetary union (EMU), and the general trend of privatisation.

Monetary and fiscal policies in Europe

Looking back

The second half of the last decade will be remembered as one during which policymakers pursued low inflation and low budget deficit policies. This has had a number of major implications for financial markets.

Under the higher inflation era of the late eighties, investors had become accustomed to high nominal rates of return on their investments. The advent of a low inflation era across the European Union sharply reduced the inflation premium built into many investment returns. This led numerous investors to seek new investment avenues in the search for higher nominal rate of returns than they were able to obtain on traditional savings instruments, such as savings and time deposits at financial institutions and government bonds.

The drastic reduction in budget deficits across the European Union and in North America also had a great impact on financial markets. Sharply reduced new public debt issues reduced opportunities for financial intermediaries and retail investors alike to invest in government debt instruments. Thus, this fiscal policy factor also contributed to shift investors' savings directly, or indirectly via financial intermediaries, towards increased private sector financial investments, mainly through equity. At one point in the late nineties, the expected reduction in new public debt issues was so large that a number of commentators began to worry about the potential implications of this new development for the liquidity of financial markets and the determination of the risk-free rate that anchors the whole credit rate structure (Schinasi, Kraemer and Smith, 2001).

Looking forward

The issue is whether these two policy factors continue to be significant drivers of change in financial markets in the decade ahead. Monetary authorities and governments appear to remain highly committed to pursuing low inflation policies and there is no reason to believe that this may change in the future. The situation with fiscal policy is very different. As a result of the economic downturn, many European Member States, especially the larger ones, are struggling to meet their budget deficit targets and serious consideration is currently being given to postpone the target date for achieving a balanced budget. While, at the present time, the private sector's financing needs are more limited and new investment in physical capital is often postponed to sunnier days, a temporary increase in budget deficits is unlikely to alter significantly the evolution of European financial markets. However, persistently larger-than-previously-expected budget deficits would have a significant impact as a substantial share of private savings would have to be directed to the public sector instead of the private sector.

In addition to the impact of the general thrust of fiscal policy, one specific aspect of fiscal policy, namely privatisation, played a major role in shaping financial markets in the nineties.

Privatisation

Looking back

Privatisation of public enterprises played a major role in shaping financial markets in industrialised economies in the nineties, especially in Europe. It generated considerable business for financial institutions and contributed to reduced budget deficits. But, more importantly, it enticed many households to invest in equities, many for their time in their lives. Indeed, in some countries such as the UK, one of the explicit purposes of privatisation was the spreading of an equity-ownership culture among the population at large.

What started as a relatively small trend in the late eighties rapidly gained momentum through the early nineties. The OECD estimates that total privatisation proceeds grew from US \$ 16 billion in 1990 in the OECD countries to a plateau of more than US \$ 95 billion per year over the period 1997 to 1999 (Mahboobi, 2002). A peak of US \$ 100.6 billion was reached in 1998, with the full or partial privatisation of a number of telecommunications operators in continental Europe, such as Deutsche Telekom and France Telecom.

However, privatisation sales and proceeds have fallen sharply since 1999, to US \$ 20.6 billion by 2001 and probably significantly less in 2002 as market conditions are not very propitious and the field of privatisation candidates has shrunk considerably.

Looking forward

While a number of planned privatisations have been postponed as result of the weak equity markets and the general deterioration in the economic climate, the inventory of potential assets for sales has shrunk considerably. Therefore, one would not expect, in general, to observe a large upswing in privatisation sales in the European Union over the coming years, with the exception of a few countries such as France that have been slower in bringing their public utilities to the market. However, in light of the general population's disappointment with the performance of the equity bought in previous privatisations, it is unlikely that these future privatisations will be geared towards retail investors. Their risk appetite is likely to have shrunk considerably

Increased willingness by households to take risks

Looking back

The development of an equity ownership culture in Europe was encouraged by a number of factors, namely: stable macroeconomic conditions, low inflation and low nominal rates of return on traditional savings instruments, privatisation and the push towards 'popular' capitalism, financial product innovations and last, but perhaps most importantly, the recent stock market bubble and the high returns that could be earned with no or few perceived risks. According to a recent study for the *Observatoire de l'Épargne Européen*, by the end of the nineties, 17.3% of households in France, Germany, Italy, the Netherlands and the United Kingdom were holding stock directly (Guiso et al, 2002). Including indirect stock ownership through mutual funds, the overall stock market participation stood at almost 50% in the United Kingdom and the United States, 33% in the Netherlands, 23% in France, 20% in Germany and 15% in Italy (Guiso et al, 2002).

The data from the ECB reported in Table 5 clearly shows that the boom in equity investment occurred over the period 1997-1999, most likely on the basis of unrealistic assessment of risk and likely returns over the longer run. For example, in 1998, households allocated almost 65% of all their financial investments to equity, whereas three years earlier their investments in equity accounted for only 0.3% of all their financial investments.

Table 5: *Importance of equity investments (in total acquisitions of financial assets by households in the eurozone)*

Year	Net acquisition of financial assets (billions of euros from 1999 and billions of ecus until 1998)	Proportion of shares and other equity in total acquisitions of financial assets (in %)
1995	430.9	0.3
1996	438.8	21.3
1997	425.3	45.8
1998	449.0	64.6
1999	479.8	42.8
2000	418.0	31.0
2001	408.2	18.0

Source: *London Economics, using ECB data*

This exceptionally large shift towards equity investment came at the expense of both traditional bank deposits and bond holdings (see Table 6). In fact, in 1997 and 1998, households in the eurozone reduced their holdings of bonds and similar market-debt securities to finance their acquisitions of shares. However, by 2001, the pendulum had swung back sharply, and households again favoured traditional banks and market-debt instruments. This trend towards greater security will most likely have continued into 2002.

The final interesting point to note is that, since 1995, households have devoted a growing share of their financial investments to insurance products. To the extent that insurance companies themselves are exposed to movements in the stock market and households may find that their overall portfolio investments are more sensitive to movements in equity prices than they had anticipated. This is certainly the case in the United Kingdom where life insurance companies invested a significantly larger proportion of their assets in equity than their European counterparts.

Table 6: *Importance of other investment instruments (in total acquisitions of financial assets by households in the eurozone)*

Year	Proportion of currency and deposits in total acquisitions of financial assets (in %)	Proportion of securities other than shares in total acquisitions of financial assets (in %)	Proportion of insurance technical reserves in total acquisitions of financial assets (in %)
1995	42.3	19.1	41.4
1996	33.2	5.5	43.1
1997	16.3	-4.4	50.7
1998	21.3	-25.7	45.5
1999	24.0	1.4	50.6
2000	12.5	19.9	58.1
2001	43.8	25.1	57.4

Source: *London Economics, using ECB data*

Looking forward

In the absence of a substantial rebound in equity prices and rapid resolution of the corporate governance problems that have come to light since the bankruptcy of Enron, it is unlikely that households will return in droves to equity markets over the foreseeable future. Many will need to rebuild their assets and, in general, they are more likely to favour security over risk-taking, and prefer the types of savings instruments offered traditionally by banks and other financial

institutions. More generally, the substantial wealth losses incurred by equity-owning households may hold back growth in the near term as recent studies suggest that household consumption in Europe may have become more sensitive to variations in financial wealth than in the past (Boone et al, 2001).

Growing importance of non-bank financial intermediaries

Looking back

The development of an equity-owning culture in the nineties stimulated the growth of non-bank financial intermediaries, as households often preferred to invest indirectly in stock markets via intermediaries such as mutual funds or life insurance companies. This trend was further supported in a number of countries where households were given greater responsibility for their own pensions, and public pension policy aimed to reduce the future burden of public pensions by promoting private pension schemes.

The data in Table 7 shows that financial assets of non-financial intermediaries have grown very rapidly in all EU Member States in the nineties, often posting growth rates that are twice as high as the rate of growth of nominal GDP, and in some cases much more.

Table 7: *Financial assets of institutional investors*⁽¹⁾

Country	Financial assets (as per cent of GDP)			Portfolio composition of institutional investors		
	Level in 1992	Level in 1999	Growth rate: 1992 to 1999	Bonds, as per cent of total assets	Equities, as per cent of total assets	Increase in the share of equity, 1990 to 1999, in percentage points
Austria	24.1	68.4	183.8	50	15	10
Belgium	47.2	101.9	115.9	41	38	19
Denmark	55.7	98.0	75.9	47	46	25
Finland	41.1	92.1	124.1	42	48	21
France	61.9	125.4	102.6	47	42	20
Germany	34.0	76.8	125.9	40	28	19
Greece	3.0	40.1	1236.7	23	43	-3
Italy	21.8	96.9	344.5	53	23	7
Luxembourg	1,74.3	4,72.3	171.0	59	29	..
Netherlands	131.5	212.8	61.8	28	43	29
Portugal	18.3	50.8	177.6	57	18	16
Spain	21.9	65.4	198.6	52	24	13
Sweden	88.8	137.8	55.2	49	73	45
United Kingdom	131.3	226.7	72.6	14	68	2

⁽¹⁾ Insurance companies, investment companies, pension funds and other forms of institutional savings

Source: *London Economics and OECD (2001)*

Generally, the sharp rise of financial assets held by institutional investors occurred during the second half of the nineties, reflecting a combination of rapidly rising stock markets and a significant inflow of new funds.

Moreover, this rapid growth in total financial assets owned by institutional investors was accompanied by a large shift towards equity in their portfolio. In many countries, the share of equity in total assets held by institutional investors jumped by more than 20 basis points in the nineties.

Looking forward

It is unclear how the importance of institutional investors will evolve over time. On the one hand, no recovery or only a limited rebound in stock markets will dampen investors' enthusiasm for investing in equity-related instruments that had increasingly been offered by institutional investors. On the other hand, the looming pension crisis and need to shift increasingly towards private pensions may boost these institutional investors further. For example, some observers estimate that Europe's corporate pension industry will grow by € 13,500 billion to € 17,000 billion by 2020 as governments force individuals and companies to pay into private pensions schemes (Ftfin, 2002). Banks and insurers are expected to be the main beneficiaries of such a development.

Venture capital

Looking back

Another particular feature of financial markets in the nineties, especially in the second half of the last decade, is the emergence of a strong venture capital industry in Europe. While the overall size of the European venture capital industry is still much smaller than in the US and varies significantly across Europe (Schertler, 2001), by the end of the decade it had become a major financial player and provided critical funding to a large number of companies.

Table 8: *Venture capital in Europe and the United States*

	1990	1999	Growth rate – 1990 to 1999
Investments ⁽¹⁾ in enterprises at early stages of development (millions of euros)			
- European Union	0.3	2.8	639%
- United States	1.0	9.2	823%
Investments ⁽¹⁾ in enterprises at expansion stage (billions of euros)			
- European Union	1.9	6.6	238%
- United States	1.4	22.6	1517%

⁽¹⁾ Investments are deflated using consumer price indexes (1995=100) and converted to euro using an annual average exchange rate.

Source: Schertler, *Venture capital in Europe's common market: a quantitative description* (2001)

Again, it is interesting to note that almost all of the rapid growth in venture capital funds, and more generally private equity funds, occurred during the second half of the last decade. Until the mid-nineties it seems that venture capital was not a significant business source of funds. It is also worthwhile to observe that:

- the two most important sources of funds for the private equity markets in Europe are banks and pension funds (Schertler, 2001);
- the relative importance of banks has declined substantially with both types of institutions each now accounting for about a quarter of new funds raised for private equity investments.

Looking forward

The burst of the dotcom bubble, weak stock markets more generally and below par economic performance have taken the shine away from venture capital and private equity funding and investments. In 2001, total new private equity and venture capital funds in Europe dropped by 20%, from €48 billion to €38.2 billion. Recent quarterly data shows that the decline has continued into 2002. Total new private equity and venture capital funds fell to €21.2 billion (at an annual rate) in the first quarter of 2002 and a paltry €6.4 billion (at an annual rate) in the second quarter of the year (European Private Equity and Venture Capital Association, 2002).

Weighing up these figures, the outlook for private equity and venture capital funds appears to be relatively subdued. This industry appears unlikely to be a major source of funds over the coming years in the absence of a solid rebound in equity prices and renewed confidence in stock markets.

Restructuring and consolidation in the financial sector

Looking back

Many of the factors reviewed in the previous sections have exerted considerable competitive pressures on traditional financial sector players. Each faced new players in the field and increased competition from other segments of the financial industry.

The borders between various types of financial sector activity often became blurred and some observers expressed concerns about the risk of significant disintermediation, a phenomenon whereby the mobilisation of savings for investment purposes is mainly undertaken by financial institutions (stock markets, pension funds, life insurance companies) other than banks. Such a development would obviously have serious implications for the implementation of monetary policy, and more importantly, for the banks themselves.

Academic studies do not appear to find strong evidence of disintermediation in the first half of the nineties (for example, Schmidt, Hackerthal and Tyrell, 1998). However, these authors suggest that intermediation chains are getting longer with non-bank financial intermediaries becoming more active in mobilising capital from non-financial sectors. In combination with the trend towards securitisation of bank liabilities, this change increases the funding costs of banks and may have put banks under pressure, particularly in France.

This being said, an examination of the data since 1995 suggests that perhaps some mild disintermediation has occurred. While it is beyond the scope of the present paper to describe in great detail the flow of funds between various sectors of the economy, it is interesting to recall that, during the stock market boom, households in the eurozone tended to invest more in equities and save less in the form of bank deposits (Tables 5 and 6). Non-financial corporations show a similar trend in terms of their financial investments but, with regard to their liabilities, they did not reduce their reliance on financial institutions as providers of funds (Table 9).

Table 9: *Non-financial corporations in the eurozone*

Year	Net incurrence of liabilities				Net incurrence of assets		
	Currency and deposits	Securities other than shares	Loans	Shares and other equity	Securities other than shares	Loans	Shares and other equity
1995	15.2	4.4	18.1	29.3	-62.4	90.1	64.8
1996	20.8	-5.3	21.1	32.8	2.5	52.0	42.5
1997	10.1	-5.3	19.2	39.1	4.2	53.7	38.8
1998	13.1	-2.3	21.0	47.8	5.4	51.3	41.5
1999	4.1	9.8	29.6	50.7	6.8	58.8	32.4
2000	8.8	8.7	20.9	51.5	5.5	52.6	41.5
2001	14.3	9.5	25.4	33.9	14.2	47.4	37.5

Source: *London Economics*, using ECB data

Whether financial disintermediation was important or not in the nineties, it is clear that financial institutions engaged in a major wave of consolidation and restructuring. Each segment of the financial market was aiming to gain a competitive edge over the others and, within each segment, competitors jostled to gain the upper hand. Generally, this involved mergers, acquisitions and the establishment of strategic alliances.

In the equity market, various stock exchanges merged or attempted to merge in order to benefit from economies of scale and deeper market liquidity. In doing so, they created new, junior stock exchanges to capture a larger share of the business related to the funding of new or emerging companies and developed a whole range of products and services to attract increasingly footloose clients. Some notable examples of these developments are: *Euronext* resulting from the merger of the Amsterdam, Brussels, Lisbon and Paris stock exchanges; the failed attempts to merge the *Deutsche Börse* with the London Stock Exchange; the creation of the *Neuer Markt*-network of junior stock exchanges, etc.

In the life insurance industry, many mergers took place with institutions looking to cross-border acquisitions and mergers in order to consolidate their market place. The banking sector experienced a similar unprecedented wave of merger and acquisition activity.

The comprehensive review of the consolidation trends in the financial sector established by the Group of Ten (2001) shows that merger activities accelerated in the nineties, especially in the last three years of the decade, as banks sought opportunities to exploit economies of scale and scope. The single bank-insurance institution (or 'bank assurance' model) was much in favour in continental Europe during this period as it was supposed to generate large business synergies. Consequently, a significant number of large and occasionally complex financial institutions have been created.

The report also notes that, so far, most mergers occurred within national borders, either in similar segments or across different segments. As a result of this restructuring and consolidation, the number of banks in each country has generally fallen and concentration (on a deposit basis) has tended to increase. However, the structure of the banking industry still varies significantly across the European Union. It is judged by the Group of Ten to be unconcentrated in a few nations (such as Germany) and highly concentrated in Belgium, France, the Netherlands and Sweden, with the remaining EU Member States falling somewhere in between.

Looking forward

Some of the fundamental forces that encouraged consolidation and restructuring in the financial sectors will continue to be felt. In particular, the ICT revolution and the drive towards the completion of the single market in financial services will continue to push financial institutions to increase efficiency and become more competitive. The precise shape of further consolidation is, however, unclear.

In the banking sector, the bank assurance model does not appear to have delivered the expected efficiency gains and those who pursued this route are re-evaluating their approach. More generally, questions are being raised about whether any efficiency gains have been achieved from the recent spate of mergers and acquisitions. For example, Berger (2000) suggests that a large potential for efficiency improvements exists, but only a small part of these potential gains have been realised so far.

Similarly, it is not clear how the proposed investment services directive will impact on the present stock exchanges. This directive offers complete freedom to provide stock market services in the European Union and alternative platforms for executing equity trades. Some observers believe that it will favour the larger markets such as the London Stock Exchange, while others express concerns about potential shifts to off-market trading systems.

The bottom line is that the financial sector's restructuring, merger and acquisitions phase is far from completed in the European Union and that many further changes are likely to occur.

Conclusions of the retrospective

The table below summarises the expected influence of the key drivers reviewed in this section. The main conclusion that one can draw is 'more of the same'. All of the main factors that contributed to shape financial markets in the nineties are expected to continue to do so over the present decade, with the exception of the privatisation driver and, perhaps, the venture capital driver.

Over the coming years, however, a set of additional factors reflecting new, contemporary pressure points and concerns will also become significant drivers of change in financial markets. These additional factors are reviewed in greater detail in the next chapter.

Table 10: *Key drivers of change in financial markets in the nineties.*

Will they continue to be significant agents of change in the future?

	Yes	No	?
ICT revolution	✓		
Globalisation	✓		
Monetary and fiscal policies	✓		✓
Privatisation		✓	
Increased willingness to take risks by households			✓
Restructuring and consolidation	✓		

Today's new pressure points ³

Economic outlook

In the spring of 2002 there was great optimism that the recovery from the 2001 slowdown had taken solid root. However, nowadays the outlook is much less clear. Vastly divergent views are being expressed about where the world economy is likely to head over the coming year and all economic agents face an exceptionally high degree of uncertainty. The current developments may well prove to be just a temporary pause on the path back to sustained growth. But, in light of the increased uncertainty, it is more than likely that investors will adopt a highly cautious approach in the near future. In the scenarios presented later on, different views about the medium term will be one of the factors distinguishing the scenarios.

Distrust in large companies and disillusionment with stock markets

Perhaps the most important new factor is the general lack of trust in stock markets and large corporations that many polls report nowadays. As long as stock markets continue to perform badly, many of those who had invested for the first time in equities in the nineties will remain disappointed, occasionally even feeling betrayed, by the general equity investment culture and are unlikely to invest again over the foreseeable future. This would obviously favour retail banks as they would face fewer competitive pressure from other providers of financial assets.

If the recent problems with the governance of corporations and financial institutions were robustly and credibly addressed and stock markets rebounded quickly, and if a new fad were to grip equity markets, many of these disappointed investors might return again to stock markets. After all, past financial mistakes tend to be forgotten quickly.

It is also important to note that investors are not the only ones to be disappointed with the performance of equity markets. Many owners of companies who floated part of the company's capital on the stock market during the nineties feel that the stock market vastly undervalues the performance of their business. In their view, little is to be gained by remaining a listed company and a new trend towards delisting companies appears to have emerged.

Corporate governance

Numerous exercises are under way with a view to improve the governance of non-financial corporations and financial institutions alike. While it would take many pages to describe the proposals currently being put forward, debated or implemented in the United States and the European Union, it suffices to note here that they all in one way or another aim to increase accountability, disclosure and transparency and to level the playing field between various types of investor groups.

Investors will be more able to assess the true financial performance of a company. At the same time they will be more confident that they will receive truthful and unbiased advice from financial intermediaries.

Some proposals such as the Sarbanes-Oxley Act in the US and many others aimed at preventing conflicts of interest related to financial research at investment banks directly target the prevention of the crasser excesses of the late nineties. This is also true for the accounting reforms to bring the costs of stock options onto the balance sheet and provide for a

³ The many developments of financial markets also give rise to new regulatory challenges. In the forward-looking scenarios, it is assumed that policymakers and regulators maintain sound and safe financial systems. The details of the new regulatory measures that would be necessary are not addressed as such a topic is largely outside the scope of the present work.

better accounting of the off-balance-sheet special purposes vehicles used by a number of businesses. A number of other reforms seek to establish a common set of rules within the European Union and to strengthen the single market. These include the proposed EU directive on take over bids or the proposal of a European company statute put forward by the Competitiveness Advisory Group to the European Commission.

An issue that has attracted considerable scholarly attention is whether corporate governance systems have converged, either as a result of deliberate policy or financial market pressures. Recent studies give somewhat conflicting conclusions. For example, Guillen (2000) finds no convergence while Palepu et al (2002) note little convergence in actual governance practices although, at a legal level, some degree of convergence is observed.

A more detailed analysis of corporate governance in Europe finds some convergence between the Anglo-Saxon model and the continental European model (Hort, 2002). The development of the market for corporate control in countries such as Germany, where hostile takeovers were virtually unknown, and the increased importance of disclosure, auditing and intermediation in different countries are seen as proof of the convergence process. Nevertheless, the author goes on to stress that many differences remain and these reflect a country's tradition, history and culture and will, therefore, not change quickly.

It is essential to note that, despite the many reforms underway, considerable differences in corporate governance are likely to subsist in the coming years. However, financial integration in Europe may have significant implications for the preferred model of corporate governance. Given that financial integration in Europe improves transparency and reduces information asymmetries as well as monitoring, Buch and Heinrich (2002) argue that the European continental corporate governance model is likely to shift towards less concentrated ownership, less financial leverage and a more market-based remuneration of senior management. Thus, the relative importance of banks as owners and suppliers of funds to businesses would decrease and stock markets would become relatively more important financial actors in Europe. Since it is difficult to quantify precisely the market share shifts which are likely to occur, Buch and Heinrich's study stresses the close relationship between financial integration, financial market structure and corporate governance.

Corporate social responsibility

Finally, the increased attention given to corporate social responsibility (CSR) may also have significant implications for financial markets.

If businesses are required to account for the impact of their actions to various stakeholders, and to consider the implications for a long-run sustainability of the business, this will create a longer-term view. Such a development should divert financial analysts' and investors' attention away from short-term financial results and force them to adopt a longer-term perspective in their assessments of the performance of a company. This more patient approach to investing would allow companies to take a longer view in their strategic planning, which would contribute to improved business performance over the longer run as many expect.

On the other hand, a badly-handled implementation of CSR may divert management's attention from more critical short-term issues and result in a less satisfactory performance than would have otherwise been observed.

In terms of financial markets, the main implication is that socially responsible investment (SRI) will become increasingly important. In response to public demand for SRI, most financial sector actors are likely to offer some vehicles for SRI. Therefore, it is not clear whether SRI will provide a competitive edge to any of the financial market participants. However, SRI may become an important factor in the allocation of private sector savings among various companies, with those committed to CSR and stronger CSR principles being favoured in the allocation of the SRI funds.

At issue is whether this likely discrimination on the basis of CSR will be important enough to result in a credit crunch for non- or weak-CSR companies.

Looking ahead, the scenarios will assume that all companies will adopt some form of CSR in the European Union and that any SRI-related discrimination among companies will be either too small to be noted at the macroeconomic level or that alternative sources of funds will close the gap.

Future pressure points

Looking ahead, two important pressure points show up over the horizon. These are discussed in detail below.

Pension reform

The first relates to the long expected, and often postponed, pension reform in most EU Member States that will be required to address the looming public pension problem. The combination of an ageing population and relatively slow productivity growth will result in such a burden on public finances that it will be very difficult to maintain sound budgetary policies.

Therefore, a large number of experts have advocated a shift from publicly funded, generally pay-as-you-go, pension systems to privately funded pensions based on past contributions to the pension fund. Given the long lead-time required to build viable private pension systems, most experts have advocated shifting as rapidly as possible to the private pension system.

This will obviously have a major impact on the structure of the financial services industry as significant amounts of new savings would need to be channelled through pension funds and invested in various instruments. Paradoxically, it may benefit both non-bank financial intermediaries (pension funds, life insurance companies, etc.) and stock markets as the savings channelled to these non-bank financial intermediaries will need to be invested in capital market securities yielding significant returns.

Basel II

The new regulatory capital framework (New Basel Capital Accord, Basel II) that is currently under discussion for intended implementation in 2005 will result in a closer alignment of the risk taken by banks and some other financial intermediaries, and the capital these institutions will be required to hold as a protection against potential losses.

While, in principle, Basel II should not increase the capital requirements for the sector as a whole, it will probably have a varying effect across the banking industry, with larger banking benefiting from reduced capital requirements relative to the current regime and smaller banks requiring potentially more capital. It may also affect the price and availability of banking funds to various sectors of the economy as lending to some sectors may require a higher capital charge than at the present time (Danielsson et al, 2001 and Resti, 2002). Although the precise details of Basel II are still under review and are likely to change in the near term, it suffices to note here that they may favour larger banks and thus impact on the precise shape of the future landscape.

The future: three scenarios

Looking ahead, a number of questions arise:

- Will banks still have a future (Bossone, 2001, Schmidt, 2000)?
- What will be the impact of technology (Claessens et al, 2002, Engen, 2002, Fawcett, 2002, Mishkin and Strahan, 1999)?
- Will the restructuring process continue (Belaïsch et al, 2001, Ibanez and Molyneux, 2002)? What about the shape of future stock markets (Murray, 2001)?
- How will regulators work together (Ernst & Young, 2002)?

The list of issues that the future of financial markets raises is almost limitless, reflecting the complexity of the situation.

However, as the focus of the present work is on the potential impact of future market developments on the financing of business activities, the scenarios below will identify the factors that seem to be critical in shaping financial markets to one or another direction. The fundamental question is whether capital markets - debt and equity - are likely to replace financial intermediaries, banks in particular, as the main providers of funds. In other words, will there be a form of convergence towards the US and UK models of business finance?

Until very recently, many, but not all, commentators were of the view that capital markets were indeed poised to become a major force and supplant financial intermediaries as the main financiers of business. However, the drop in equity markets and the uncertain economic outlook certainly warrant a review of this school of thought.

The sections below outline first the factors that will be common to the three scenarios, identify then the key factors that will vary across the scenarios and finally provide an analysis of the likely outcomes of these scenarios and highlight their key differences.

Financial market drivers common to the three scenarios

A number of factors will be assumed to be common to all three scenarios. These are:

1. ICT revolution:

One can assume that the impact of the ICT revolution will continue to be felt in all scenarios.

- Competition from electronically-based providers of financial services will continue to be relentless, forcing traditional providers of financial services to continue to reduce operating costs and improve the efficiency of their organisation. This applies to the banking sector as well as to other financial intermediaries and capital market institutions, such as stock exchanges.
- A number of observers are of the view that the ICT developments seen so far are only the tip of the iceberg and that the potential of internet-based systems remains yet to be exploited.
- In practical terms, this implies considerable service and product innovation for the customers of financial services and further drive towards consolidation.

- In itself, however, this factor should not tilt the balance in favour or against financial intermediaries relative to capital markets.

2. Monetary policy:

This report will assume that monetary policy remains resolutely anti-inflationary over the horizon of the scenarios.

- While this factor should be roughly neutral in a period of low inflation, it could favour those financial services providers that provide interest-sensitive products to savers if inflation were to pick up and the European Central Bank significantly tightened monetary policy.
- In the scenarios, it is assumed that inflationary pressures remain minimal over the horizon of the scenarios. Thus, this assumption imparts no particular bias to the analysis.

3. Completion of the single market in financial services:

It is assumed that the European Union will complete the implementation of the Financial Services Action Plan on time or only with a minor delay.

- The major impact of the creation of a single market for financial services will be a sharply increased cross-border competition, putting further pressures on all providers of financial services to control costs and increase their efficiencies.
- Like the ICT driver, this will underpin a continued process of consolidation, mergers and acquisitions, with perhaps a greater emphasis than in the past on cross-border transactions, leading perhaps to the emergence of truly pan-European organisations.
- There is no reason to believe that it will favour one type of financial services provider over the other. However, to the extent that substantial economies of scale exist in the provision of various types of financial services, it may favour the emergence of larger entities in each segment of the financial services industry.

4. Globalisation does not recede:

In the three scenarios, it is assumed that the current degree of trade and financial integration remains stable or even increases.

- The various trade disputes between the major trading partners are assumed to be eventually resolved and no measures are taken that would undermine the current system. Overall, the impact of this assumption is neutral on the outcome of the scenarios.

5. No significant financial crisis has a lasting impact on the economic outlook:

- The report assumes that any serious financial crisis will be quickly addressed and resolved by international financial institutions such as the IMF and the World Bank, governments, central banks and regulators.
- It is possible that a new emerging-market crisis may erupt, perhaps in Latin America, or that the persistently large US current account deficits eventually may result in a serious exchange rate crisis. But the following scenarios assume that policymakers will be prompt to act and take all the necessary measures to contain the crisis and limit its effects.

- Any such serious crisis will lead to a flight to safety, favouring those investment instruments perceived as the safest at the time of the crisis. More often than not, such an action tends to favour government securities and other instruments such as gold and, to a lesser extent, deposits in banks perceived as sound in countries perceived as safe. In no cases does such a crisis benefit the equity market.

6. No serious banking crisis:

- In the scenarios, it is assumed that any potential banking crisis is quickly contained by policymakers and the banking system is not submitted to a systemic shock.
- In the absence of strong action by the relevant authorities, all financial services providers are likely to be affected by investors fleeing to what they perceive at that time as the safest of the safest instruments.

7. The drive towards better governance of corporations and financial institutions is pursued with equal intensity in the three scenarios:

- This may favour capital markets at the expense of banks in continental Europe since the benefits of bank-finance as a mechanism of corporate governance no longer arise.

8. Corporate social responsibility becomes part of mainstream economic governance:

- The previous chapter argued that the main impact of this policy will likely fall on non-financial businesses as they seem to be more committed to CSR and may, hence, benefit from greater SRI funding.

9. Basel II will be implemented and will have a broadly similar impact across the three scenarios.

10. Restructuring and consolidation:

Restructuring and consolidation within the financial sector will continue, irrespective of the economic and financial outlook.

- However, this process will be much more intense in the scenarios in which economy growth is slow as pressures to control costs will be far greater in such a case.

All but one of the assumptions made above are neutral in terms of their impact on the relative importance of financial intermediaries and capital markets as providers of finance to businesses.

The number of factors listed so far will be treated as identical in all three scenarios. Privatisation is not included in the list above because it appears not to be a significant factor over the medium term.

Financial market drivers that vary across the three scenarios

The three main drivers that matter critically are the general outlook for the economy, the performance of stock markets and investors' trust in equities. The discussion begins with a review of these three factors and continues with a presentation of some other relevant factors.

1. The pace of recovery:

It ranges from prolonged anaemia to a robust rebound in the near term (Table 11):

- It is important to remember that the figures below do not represent forecasts of the likely path of economic activity in industrialised countries, but are simply assumptions that help to underpin various scenarios.
- The figures for 2000 to 2003 in the upper range scenario are from the latest IMF World Economic Outlook. Thereafter it is assumed that economic growth continues to rebound and tends to return to the high growth path that was observed in the late nineties. Underpinning such a scenario are rapidly growing business investment, a return to general optimism and a pronounced rebound in stock markets.
- In the middle range scenario, it is assumed that economic growth resumes, but at a much more subdued rate, and remains somewhat below potential output growth for most of the period. Unemployment is likely to continue to increase somewhat in such a scenario. Some business investment takes place but the figures are nowhere near the levels reached during the previous investment boom. Equity markets remain subdued, although the resumption of economic growth and renewed profits provide some modest upward stimulus to stock markets.
- Finally, in the lower range scenario, the economy remains in the doldrums for a prolonged period. Unemployment rises sharply, little business investment takes place and equity prices continue to fall for a while before rebounding somewhat.

Table 11: *Economic growth hypothesis in the advanced economies under the three scenarios*

	2000	2001	2002	2003	2004	2005	2006	2007	2008/9/10
Upper range	3.8	0.8	1.7	2.5	3.0	3.5	3.5	4.0	4.0
Middle range	3.8	0.8	1.7	2.0	2.0	2.0	2.5	2.5	2.5
Lower range	3.8	0.8	1.7	1.0	1.3	1.5	1.7	2.0	2.5

Source: *London Economics*

2. Future evolution of stock markets:

Despite many efforts and much research on this topic, forecasting the precise course of stock markets remains a highly imprecise art. However, it is possible to describe qualitatively stock market growth characteristics that one would associate with the three economic growth scenarios described above.

- In the upper range scenario, one would expect stock markets to rebound significantly from their recent lows, albeit without fully reversing their losses from the 2000 peak since this peak was based on unrealistic evaluations. However, it is not unreasonable to expect a rebound to a pre-boom level, such as the level prevailing in 1997. Following this rebound, stock markets would be expected to post only moderate growth thereafter, in line with the rate of growth of world nominal income. The key point is that, even by 2010, the markets will not have fully recovered losses since 2002.
- In the middle range scenario, one would expect a more muted rebound followed by more tepid growth for many years. A return to 1997 levels is unlikely to occur for a number of years. In this scenario, the stock market recovers only to the level prevailing in 1998. The large and mostly speculative run-up of 1999 and 2000 is never recovered.

- Finally, in the low range scenario, one would not expect stock markets to rebound in the near term but to show further declines before bottoming out at perhaps 1994/95 levels and then, very slowly, to claw their way back up. In this scenario, the stock market returns at best to the level prevailing in early 1996, well before the dot-com craze hit equity markets.

As already mentioned, these are not intended to be stock market forecasts but to provide some perspective on how stock markets could evolve under very different economic growth scenarios. For illustrative purposes, Table 12 provides the trajectory of the world stock market index for the three cases.

Table 12: *Potential evolution of the MSCI all country world stock market index (1987=100)*

	History	High range	Medium range	Low range
1990	120.2			
1991	139.2			
1992	136.9			
1993	168.7			
1994	168.0			
1995	195.1			
1996	223.3			
1997	268.3			
1998	313.5			
1999	401.2			
2000	353.3			
2001	303.5			
2002 - October 7th	214.5			
2003		268	214	190
2004		281	220	170
2005		297	230	176
2006		313	260	183
2007		332	271	192
2008		352	284	200
2009		373	297	209
2010		395	310	219

Source: *Bloomberg for historical data and London Economics*

In the high-range scenario, the stock market grows at the rate of upper range growth with an output illustrated in Table 11 plus an inflation of 2%. In the medium-range scenario the stock market shows little growth until 2005 when it starts to recover and, from 2006 onwards, it grows at the middle range rate of growth with an output shown in Table 11 plus an inflation of 2%. Finally, in the low-range scenario the stock market continues to drift downwards until 2005 and, subsequently, it grows at the lower range rate of growth with an output shown in Table 11 plus an inflation of 2%.

3. **Trust in equity markets:**

In the three scenarios, it is assumed that all necessary measures are being taken to address the known governance issues and corporate excesses of the late nineties. Thus, the only differences in trust in financial markets in the three scenarios arise from varying economic circumstances.

- In the upper range scenario, trust in equity markets is gradually rebuilt as stock markets recover; whereas in the middle range trust takes much longer to be rebuilt. Finally, in the low range scenario, trust is not re-established over the scenario horizon.

4. Households' willingness to take risks:

Obviously, the faster stock markets rebound, the greater the likelihood is that households will be inclined to take greater risks than at the present time.

- Many might be attracted back into equity markets in response to the widely accepted fact that, over the longer run, equity investments outperform other forms of financial investments. This is most likely to occur in the high range scenario.
- In contrast, retail investors are unlikely to return en masse to equity markets in the low range scenario and will be more likely to stick to safe financial instruments such as bank savings deposits and similar instruments.
- The middle range scenario presents an interesting case. It is possible that under such a scenario retail investors will be willing again to take on some risks. But, they may search for somewhat safer alternatives to straight equity investments. This may be the scenario where the euro-denominated corporate bond markets find favour with retail investors, providing for greater returns than standard instruments from financial institutions, while being a less risky investment than equity.

5. Importance of institutional investors:

This will depend on two factors: households' preparedness to invest again indirectly through mutual funds, life insurance companies and similar institutions in equity and/or bonds; and pension reform.

- Either of these two factors will contribute to the growth of institutional investors, and divert savings away from the banking sectors towards other financial intermediaries. Pension reform in particular is expected to provide a major boost to non-bank financial intermediaries.
- However, it is not obvious whether such a shift would impact on the structure of business finance. While it is true that institutional investors considerably increased the share of their financial assets allocated to equity, it is important to remember that this occurred during a period of rapidly rising stock markets.
- Looking ahead, it may well be that institutional investors will adopt a much more cautious stance.
- Therefore, in the scenarios, it is assumed that the overall impact of the growth in importance of institutional investors will have a broadly neutral impact.

Implications for financial markets

In this section, the report brings together the various elements of the three scenarios and provides an assessment of the likely landscape that would emerge under each of them. As noted before, financial institutions will continue to face considerable pressures to control and reduce costs as a result of increased competitive pressures. Further consolidation within and across the various segments of the financial industry (banks, non-bank financial intermediaries, stock exchanges, securities dealers, brokers, etc) is to be expected, both nationally and across borders. As a result, larger, perhaps truly pan-European, financial institutions will emerge in the various segments of the financial industry.

The outlook for the 'bank assurance' model, however, is less clear. The expected economies of scope that many expected are proving to be more difficult to reap than previously anticipated. In fact, it appears that some of those institutions that had strongly embraced this business model are having second thoughts.

The most probable development is that a number of different models will be pursued over the coming years and that it will take some time before it becomes clear which approach is best suited to this environment of increased competition.

Overall, businesses and households should benefit from increased competition in the financial sector through reduced financial intermediation and transactions costs, greater variety of products and services, and greater investment opportunities across the whole of the European Union.

In this regard, it is interesting to note that 'consumers still feel basically powerless vis-à-vis suppliers and ill-informed about important financial products. Consumers remain deterred from exploiting opportunities across borders for reasons of insufficient information, language problem and perceived risk' (EC, Eurobarometer 56, September 2002).

High range scenario

In this scenario, it is expected that equity markets will again attract retail investors, although the return might be sluggish at the beginning. Stock markets will continue to be a significant source of finance for businesses, but not of the scale observed in the late nineties. The banking sector will likely remain the dominant source of business finance in continental Europe over the foreseeable future.

Thus, even in this optimistic scenario, it is unlikely that one would observe significant changes in the structure of business finance in the years ahead. Bank loans will remain the major source of funds, followed by equity and bonds. The latter might, however, increase somewhat in relative importance if some retail investors reduce their risk appetite.

As a result, one would not expect to observe further substantial convergence in corporate governance that is driven by financial markets. However, policy-induced convergence in corporate governance will contribute to narrow substantially the differences in corporate governance across the European Union.

Medium range scenario

The main difference of this scenario relative to the previous one is a more muted risk appetite of retail investors. This may stimulate the growth of the nascent market for euro-denominated corporate bonds as it offers investors less risky securities than equity while providing higher returns than the traditional products from financial institutions.

A big question mark in this scenario is the future course of fiscal policy. If the present budget deficits were to persist for a long period, the new public debt issues might well attract all the funds that investors would be willing to invest in debt-market instruments. This would obviously stifle the continued growth of the euro-denominated corporate bond market.

Barring large and persistent budget deficits, one would expect bond financing to gain in importance as a source of business finance, mainly at the expense of equity finance. Bank loans, however, will remain the primary source of business finance in many continental European countries, even more so than in the high range scenario.

If budget deficits were to persist, it is unlikely that bond finance would grow significantly as a source of business finance for the reasons discussed above. In such a case, it is likely that the structure of business finance would change little over the coming years.

Low range scenario

In this scenario, retail investors are unlikely to flock back to stock markets. Even corporate bonds are likely to be considered as too risky in this scenario. Households will prefer to place their savings in financial institutions rather than risk them on capital markets.

Bank finance remains the main source of business finance and gains in importance as capital markets attract only a small share of total savings. Thus, in this scenario, the share of business financial liabilities accounted for by bank loans will increase and the share accounted for by shares will decrease, as will the share of bonds.

General conclusions

The three scenarios above have reviewed how the importance of bank finance in total business finance is likely to evolve over time.

In all three scenarios, the conclusion is that bank loans will remain the most important source of funds for business in continental Europe over the coming years.

In the first scenario, equity financing may regain some of its lost shine and, in the second scenario, bond finance may finally become a more important source of funds for businesses in Europe. In the last and more pessimistic scenario, one would expect bank finance to gain in importance in the future.

Overall, it appears unlikely that expectations, formed during the recent stock market boom, of major change in the structure of business finance will be realised soon. Loans from banks and other financial intermediaries will remain an, if not the most, important source of business finance in most EU Member States. The very large contribution of new equity issues in new business financing of the late nineties is likely to have been only a temporary deviation from a well-established pattern.

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