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The capital markets of the future: positive versus normative aspects

Capital markets are a key element in today's financial system. Their development is also central in shaping the overall characteristics of the financial system of the future. This is to say, it is worth thinking about where capital markets are heading for, what the underlying driving forces are and what the possible consequences might be.

Before the crisis, it was common wisdom to distinguish between capital *market-based*, Anglo-Saxon financial systems and continental European, *bank-based systems*, with various authors emphasizing pros and cons of each system. As the financial crisis started in 2007 and evolved, views differed on whether capital markets or banks were mostly responsible for the financial crisis and its propagation. In fact, both sectors, including their interlinkages, had a massive impact.

In response to the crisis, the authorities substantially reinforced bank regulation, more than regulation of other areas of the financial industry, such as shadow banks. SUERF addressed the issue of *Shadow Banking: Financial Intermediation beyond Banks* in a SUERF Colloquium, jointly organized with Suomen Pankki, in Helsinki on September 14–15, 2017. Combined with the need for consolidation in banking, due to margin squeeze and cost pressures, capital market financing has gained in importance relative to bank financing in continental European countries over the past years. Corporate bonds are booming. Besides, securitization, which had been identified as one source of the financial crisis, has strongly expanded again meanwhile. Global M&A activity is also expanding strongly.

So, where are capital markets heading for? In investigating this question, two principal perspectives can be adopted:

A first, positive, perspective attempts to forecast what will most likely happen. Several aspects are relevant , for instance:

- First, how will technological *game changers* such as artificial intelligence and algorithm trading affect asset management? What impact will the dismal performance of active asset management strategies and that by hedge funds have? Will the trend towards low-cost, standardized products such as Exchange-Traded Funds (ETFs) continue? How will the trend towards online brokerage and more explicit pricing of advisory services to different customer segments affect access to higher yielding investments?
- Second, what implications might the increasing importance of passively managed investment funds and ETFs have on systemic stability, if they encourage synchronized behavior? Would more global harmonization of capital market and shadow bank regulation contribute to systemic stability or the opposite?
- Third, on the d*emand side* of capital markets, the question arises how central banks' future policies towards outright asset purchases will affect global demand for low-risk fixed income products on prices and yields. When and how will a tapering of purchases happen? How about reinvestment policies? How about the size of central banks' outright securities holdings in the longer term? How about their future monetary policy toolkit and balance sheet structure? Another important factor in a long-term perspective are of course pension systems: How will future needs to save privately for pensions – globally, not only in the developed world – influence the demand for securities?

- Fourth, on the *supply* side of capital markets, the future of sovereign borrowing is key. How will sovereign debt levels evolve over the longer term? How will debt sustainability be affected by an eventual normalization of interest rate levels? What will, in fact, likely be a future „normal“ interest rate level? How will the euro area sovereign debt evolve?

A second, normative perspective asks in what direction capital markets should develop.

- What role should capital markets and shadow banks play as compared to bank financing in the future? For instance, one might postulate that capital markets should grant broader access to finance also for medium-sized enterprises, through various forms of loan bundling, tranching etc. In the EU, the project of a *European Capital Markets Union* explicitly aims to further integrate capital markets across the 28 (or 27) Member States, in order to improve financing possibilities across the Single Market for financial services and capital.
- In the euro area, a long-debated theme is how to *standardize*, *pool* or *even mutualize*, in one way or another, euro area governments' debt financing, while maintaining incentives for fiscal responsibility.
- Another relevant topic is how to *improve market pricing and avoid exuberance*, booms and busts, and how to further improve *crisis resilience*.
- Of course, normative visions of what the capital markets of the future should look like, can differ considerably depending on whose vision we are talking about: „society“, borrowers (including governments), savers and investors, monetary policy makers, regulators and supervisors, and various types of financial firms might all have different normative visions.

Finally, these two – *forecasting* and *normative* – perspectives are linked with one another. Depending on one's judgement on what various stakeholders and interest groups regard as a desirable future for capital markets, and on one's assessment of the influence these groups may have on law and rule making, one might forecast in which direction regulation and supervision of capital markets might actually develop. This would in turn affect one's forecast of how capital markets will evolve. Conversely, based on one's forecasts on the likely secular development of capital markets due to long-term trends such as technology, demographics and government debt, one might conclude that measures should be taken to reinforce or contain certain tendencies.

Obviously, the subject of this session itself could easily fill a two-day conference. Instead, this session picks out two specific topics relevant for the future evolution of capital markets. Both papers contribute to the first, positive or forecasting, perspective by providing deep insights into the subject matter, thus allowing more informed forecasts on their potential usefulness and limitations. At the same time, both papers contribute to the second, normative, perspective on the future of capital markets, by identifying problematic

areas, by weighing pros and cons, and by offering solutions to the problems.

The first paper by *Professor Nikolaus Hautsch, University of Vienna*, addresses a complex topic which is seen quite ambivalently among economists, regulators and in the public debate, namely high frequency trading. In line with this ambivalence, Professor Hautsch will address both the costs and benefits of high frequency trading.

The second paper by *Professor David Yermack, NYU, Stern School of Business*, addresses the interesting topic of smart contracts. By making a breach of contract expensive, smart contracts increase the incentive to fulfil the contract and thus increase security to the parties of the contract, without requiring trust, and in this way also economize on contracting and enforcement costs. Taking a posi-

tive forecasting perspective – one might – due to their advantages, expect smart contracts to gain in importance in the future. Taking a normative perspective, on might even welcome this for reasons of efficiency, as long as possible risks are understood fully and taken care of.