Box 2

THE DEVELOPMENT OF A HIGH-YIELD BOND MARKET IN THE EURO AREA

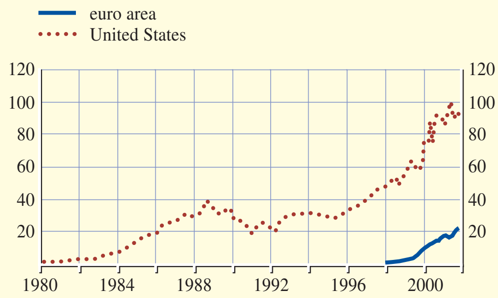
A mature corporate bond market working alongside a sound banking system is an important feature of a well-developed financial system. Within the corporate bond market, the existence of a deep and efficient high-yield bond market (i.e. a market for bonds rated below investment grade by credit rating agencies)[1] can help to smooth the financing of a greater number of corporations by providing a source of external funding in addition to bank loans and equity financing. This is particularly useful for small and medium-sized enterprises and new, fast-growing sectors with increasing financing needs. In addition, from a macroeconomic perspective, the high-yield segment of the corporate bond market can be a useful source of information on future economic activity and current credit conditions. This is because the spreads of high-yield bonds over higher-rated financial instruments (such as government bonds) are often valuable indicators of market participants' perceptions about future corporate defaults.

Chart A shows the amounts outstanding on the euro and dollar-denominated high-yield bond markets. In the United States the high-yield bond market started to develop in the early 1980s and declined in the early 1990s. It then picked up again after 1993, reflecting a strengthened business cycle and improving stock market developments. The high-yield bond market in the euro area, by contrast, has only grown substantially since the start of Stage Three of Economic and Monetary Union (EMU). This development seems to have been related to expectations of an intensified degree of integration in the euro area financial markets, and thus higher liquidity, triggered by the introduction of the euro. Chart A also suggests that while in the United States the high-yield bond market took some time to take off, in the euro area the market grew relatively quickly after its inception. In the first quarter of 2004, high-yield bond issuance in the euro area was around 3.0% of total gross investment grade corporate bond issuance (see Chart B).

1 Investment grade bonds are those rated at least Baa by Moody's or BBB by Standard and Poor's.

Chart A Amounts outstanding of high-yield bonds in the United States and the euro area

(EUR billions; monthly data)



Source: Merrill Lynch.
Note: Includes public issues in domestic markets denominated in local currency.

One possible further explanation for the faster development of the high-yield bond market in the euro area compared with the United States is that financial innovations tend to develop more quickly in other regions of the world if they have already proved their utility in a pioneer country.[2] In this respect, the United States had to perform the function of a pioneer, whereas economic agents in the euro area had much of the information they needed on the high-yield bond market from the outset.

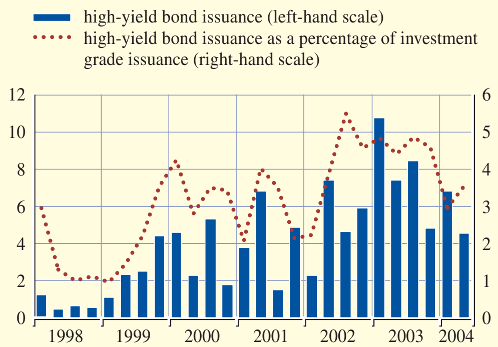
Recent developments in the euro area indicate that high-yield bond issuance remains strong. However, there were some declines in issuance volumes during the first six months of 2004 compared with the same periods in 2003 (see Chart B), as in the corporate bond market as a whole. It is likely that corporations' improved earnings in the first half of 2004 have partly reduced their need for external financing.

In the first half of 2004 the spreads of euro-denominated high-yield bonds over government bonds reached their lowest level since the euro area high-yield bond market started up in around 1998, reflecting a marked decline in spreads in 2003 (see Chart C). This suggests that credit risk as perceived by market participants has declined to low levels in the euro area, which is in line with credit rating agencies' tendency in recent quarters to reduce the number of corporate downgrades relative to upgrades. Overall, the cost of financing in the euro area high-yield bond market is presently very favourable.

2 See De Bondt, G. and D. Marqués (2004), "The high-yield segment of the corporate bond market: a diffusion modelling approach for the United States, the United Kingdom and the euro area", ECB Working Paper No 313.

Chart B Gross high-yield bond issuance in the euro area

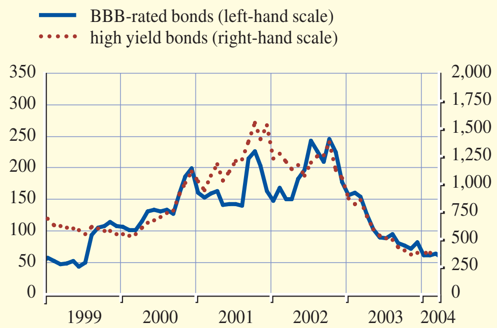
(EUR billions; percentages of total investment grade issuance)



Source: Dealogic Bondware.
Note: Includes high-yield bonds issued in euro and euro legacy currencies by euro area corporations.

Chart C High-yield and BBB-rated corporate bond spreads in the euro area

(basis points; monthly average of daily observations)



Source: Bloomberg and Merrill Lynch.
Note: Spreads are calculated as the difference between the euro high-yield corporate bond yield (and the BBB-rated corporate bond index) and the yield of the euro area AAA government bond index Merrill Lynch.