

Jean-Claude Trichet: Structural and financial reforms in Europe in a global economic environment

Speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the International Securities Market Association meeting, held in Paris, on 16 June 2000.

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Ladies and Gentlemen,

It is a great pleasure for me to take the opportunity of this ISMA meeting in Paris to present some views on how European economies have entered a new era with the introduction of the euro.

First, I would like to elaborate on the pace of structural reforms, which have already produced tangible and positive effects on the growth rate in the euro zone.

Second, I will focus on the integration process which is under way in financial markets across the euro area.

1. The euro area may expect a long phase of steady economic growth sustained by the strong pace of structural reforms: further liberalization, increasing labor flexibility and government budgetary discipline

Liberalization based on privatization, deregulation and transparency has been a success

The time is long past when a significant portion of the European economy was controlled through various government bodies or regulations. The liberalization movement, which accelerated substantially with the development of the European Union and principally the completion of the single market, includes three aspects:

- A significant privatization movement, which has spread throughout all of Europe. Since 1990, Europe's governments have sold more than \$200 billion worth of state companies. This movement was particularly important in Italy, France and Germany, where sales represented almost three-quarters of the total amount. The change in ownership has paved the way for corporate strategies benefiting from an open access to financial markets.
- Another force at work in Europe is deregulation. The change is particularly noticeable in several key sectors such as telecommunications, transportation, the power supply industry and, of course, the financial sector. This movement has prompted a rapid response from regulatory bodies to monitor the introduction of market rules and ensure the appropriate functioning of fair competition throughout the entire European Union. Today, this institutional framework appears quite appropriate against a background of in-depth restructuring and numerous mergers and acquisitions all across Europe.
- Moreover, the liberalization required for the single market endeavor has been accompanied by an increasing need for transparency and accountability, which has brought substantial changes in corporate practices. More detailed rules of disclosure for financial information and competitive offers for public procurement programs have been implemented throughout a large part of Europe. This phenomenon has enhanced the overall efficiency of the European market economy.

A second series of reforms has resulted in increased flexibility in the labor market

During the past two years, employment has grown faster in Europe than in the United States. There has been strong job creation, particularly in the new economy, as can be seen in the remarkable

increase in employment in the IT companies listed on the “New market”. Employment in this sector rose by more than 40% in France and Germany.

Besides the improvement in the job situation in the euro area, which results from better economic prospects, it should be mentioned that over the past few years the European Union has embarked on determined efforts to promote structural reforms aimed at improving the functioning of labor markets.

European countries increased flexibility in the labor market, in particular by developing part-time and temporary contracts.

Let me quote some figures to illustrate this point:

- From 1995 to 1999, part-time employment rose from 14% to 17% of total employment in the euro area. This proportion is more important than in the United States, where it amounts to around 13% of total employment. More than half of overall net job creation was due to part-time employment.
- In conjunction with this development, temporary employment in the euro area rose to 15% of total employees in 1999.

It is also worth mentioning an emerging trend towards more cross-border mobility of human resources, especially among young people. More and more university degrees include a stay in one or two foreign universities, thus helping to overcome linguistic and cultural barriers in Europe.

Last but not least, a key feature which has fostered job creation in the euro area in recent years is wage moderation, together with reductions in the social charges imposed on employers. This has largely contributed to the emergence of an environment favorable to price stability and low unit production costs, strengthening the competitiveness of our European economy.

Finally, all countries have experienced significant fiscal consolidation in the 1990s

Enhanced European performances are also evidenced by the significant fiscal consolidation pursued in Europe in the 1990s. The general government deficit for the euro area fell by 3.5 percentage points between 1993 and 1997 and was brought back below the 3% threshold. Since then, deficits have continued to fall. The most recent data point to a public deficit of 1.2% of GDP for the euro area in 1999, down from 2.0% in 1998. Four countries of the euro area have managed to achieve a fiscal surplus since 1999.

The fact that European member states have made significant efforts in order to improve their public finances does not mean that the process of fiscal consolidation is over. In fact, some member states, including France, still have some way to go to meet the Stability and Growth Pact goal of budget positions which are close to balance or in surplus. In addition, there is a need to further reduce government debt levels, which remained above 70% of GDP for the euro area.

When one considers the cumulative effects of the changes currently experienced - in the field of regulations, in the labor market and in public finances - which were triggered by the single market and now by the single currency, one can be reasonably confident that the euro zone is progressively catching up with the US economy in terms of long-term potential growth.

2. The integration process of the euro-wide financial markets

Turning now to the situation of financial markets, I would like to offer a couple of comments, related to the integration of markets and the process of consolidation in the banking sector.

2.1 First, allow me to recall the important step taken on 24 March 2000 by the Lisbon European Council towards an integrated financial services and capital market in the European Union. In Lisbon, the Heads of State and Government recognized the central role of efficient financial markets for long-term European competitiveness and for the development of the new economy. The central bankers and market practitioners who are participating in this meeting share, of course, a common interest in achieving the smooth and full integration of financial markets within the euro area: both you

and us, because of the very nature of our respective jobs and responsibilities, attach the utmost importance to the smooth circulation of cash and securities across the euro zone. Indeed, it is crucial that payments of cash and delivery of securities be performed without undue obstacles throughout this very large financial area grouping so many market players keen on operating in deep and liquid capital markets.

As regards this crucial issue of financial market integration, it is needless to insist on what has already been achieved during the last eighteen months. However, it is also important to keep in mind areas where some work remains to be done.

- *The integration of interest rate markets* within the euro zone is a first, key achievement that deserves to be underscored. The high level of integration that was accomplished can be observed not only at the short end of the market, in the inter-bank and money markets, but also at the long end. Market participants across the euro area now trade according to the same rules and practices, using the same indices (for example the Eonia and Euribor references on the swap market). When looking at the behavior of the market for government securities, it is striking to see how fast intermediaries, but also issuers, have adjusted to the new environment created by the introduction of a single currency. At the same time, the advent of the euro has been the catalyst for the development of a buoyant market for corporate securities. A market for high-yield bonds is already following. I would, for example, underline the development of asset-backed securities markets in different countries, among which France, to take advantage of demand from global investors for this type of securities. Let me also mention, as regards the short end of the yield curve, the very rapid development of the market for commercial paper in euro and, in particular, the success of the Paris-based market, which has attracted large foreign issuers, thanks to its security, an appropriate regulatory framework and the efficient functioning of DVP procedures.

The euro's market share as an issuance currency reflects, to a large extent, the ability of intermediaries to promote the deep and liquid markets that issuers and investors need. Hence, as was predicted by observers, since the start of Stage Three the euro has become the second most important currency in all segments of international capital markets.

- At the shortest end of the market, the integration of the interbank market took place last year right from the start of EMU, thanks to the installation of the TARGET system, which enabled large-value payment systems to move money efficiently and safely in real time from one location to another. An important feature to have in mind is that this efficiency has been achieved not through the centralization of payment systems, but through a decentralized network in which national RTGS systems managed by NCBs are linked together. Such a structure is working well. This does not mean that we can now relax and sit back: additional improvements will have to be considered in this field. For instance, we have to keep working on reducing costs, especially concerning cross-border payments. This will certainly lead to further harmonization: the harmonization of standards and practices and also the harmonization of systems.
- The integration of the euro money market was obviously a prerequisite for the ECB and the national central banks, the so-called Eurosystem, to be able to conduct the single monetary policy efficiently. This challenge has been met successfully in a decentralized framework in which each national central bank, acting under the aegis of the ECB, is responsible for the daily implementation of monetary policy in its country, as regards open market operations, standing facilities and minimum reserves.

However, as I mentioned previously, some important work remains to be done before we can consider that the euro financial markets are fully integrated and that they contribute in the most efficient way to the best allocation of resources.

- At the juncture between the bond and the money markets, the repo market still lacks homogeneity and harmonization. This situation derives from the complex nature of this market, in which legal and settlement issues play a prominent role. The differences in

domestic legislation can prove detrimental to the development of an homogeneous repo market on a euro-wide basis and to the adoption of common market standards. As such, this issue needs to be addressed. Indeed, a lot of work has been conducted on this issue by market participants - and I know that ISMA has been a driving force in this regard - as well as by the public authorities at the European level. To a large extent, it should find its way into the directive on collateral that the European commission is about to propose to facilitate the cross-border collateralisation technique.

- As regards more specifically securities markets, the cross-border circulation and settlement of securities needs to be further enhanced. One can expect the consolidation process that is taking place among securities settlement systems (SSSs) to improve eventually the ability of market participants to move securities efficiently at lower costs across the euro zone.
- Similar remarks can be made regarding stock markets. Confronted with fierce competition coming from new entrants, our traditional stock exchanges are implementing major changes. The introduction of the euro has been a catalyst which added another strong incentive for the rationalization of all the existing market structures. These tremendous changes, perhaps we could even call them a revolution, have been sped up by the never ending improvements in technology. Indeed, the technology revolution is transforming not only the architecture of stock markets, but also the organization of bond markets. It impacts the way intermediaries and investors conduct their business. The outcome of the changes brought about by these developments are not yet well known. This is why they certainly need to be closely monitored, not only within individual firms but also at the level of supervisory bodies.
- At a moment when all activities are tending to accelerate and render location issues more acute, changes in the regulatory environment are crucial to fostering efficient financial markets. Let me mention in particular the UCITS (mutual funds) Directive and the directive on occupational pension funds, which ought to eliminate barriers to investment and, of course, the importance of the directive on take-over bids in the context of the integration of national stock exchanges.

More generally, it is very important for the European Union to accelerate reforms in the financial field. In this respect, as I said, key directives have to be laid down and transposed adequately in national laws, whereby the public authorities within FESCO and professionals (like the members of your association) should play a role to facilitate a harmonized set of principles or recommendations.

On all these subjects, we can expect a lot of progress in the following months, within the guidelines already issued by the European Commission (in its Financial Services Action Plan). France, for its part, has already expressed its intention to put these matters on the Agenda when it takes over the presidency of the European Union in July.

2.2 Coming now to the process of consolidation in the banking sector, there is no need to recall how banking and financial consolidation has sped up in recent years in Europe. Of course, this evolution is closely connected to the introduction of the euro and the creation of a single capital market. Some major players are emerging in each country of the EEC. Clearly, we have new and exciting challenges ahead of us on the way to European banking consolidation.

The bodies in charge of banking regulations, along with those responsible for the supervision of credit and financial institutions, keep a close eye on these developments.

The stance of national regulators in Europe is based on the strong and efficient coordination of banking and financial supervision, with ongoing flows of information and, where necessary, coordinated actions which may lead to the designation of a lead regulator.

Recently, several examples of such coordinated supervision between European banking authorities, such as that between the Belgian and French authorities for the DEXIA group, have shown that national supervisors are well prepared to cope with large cross-border groups.

2.3 Finally, let me say a few words on the situation of the euro in the foreign exchange market.

We have heard quite frequently during the recent months, and especially when the euro weakened against the dollar, that the cause for this situation was to be found in the supposed absence of structural reforms that disadvantaged the euro zone vis-à-vis its main competitors.

In the same vein, it is often said that the poor performance of the euro reflects the growth differential between the euro zone economy and the US economy.

Let me comment briefly on these two points. As regards the lack of structural reforms, I hope that my previous remarks have underlined that the euro countries have clearly embarked on major structural reforms - triggered by the single market and the single currency - that will bear lasting effects on the functioning of their economies. The central banks of Europe call for the pursuit and reinforcement of these reforms. At the same time, in order to serve these economies in the most efficient way, the euro financial markets are experiencing the deep and rapid integration process that I described previously.

On the second point, one has to keep in mind that the American and European economies are not positioned identically in the economic cycle, as the latter are probably at the beginning of a more robust phase of expansion. According to IMF forecasts, growth should reach 3% in the euro area in 2001, compared with 3.2% in the US.

From a central banking perspective, the present situation is clearly characterized by a misalignment of the euro if one refers to the euro area fundamentals: robust domestic growth, inflation under control, strong domestic savings, healthy external accounts.

We are, to a certain extent, in a situation symmetric to that which prevailed in 1995 when the weakness of the dollar was clearly out of line with the fundamentals of the US economy. At that time, it took a few months before a correction appeared that aligned the dollar with its economic underlying fundamentals. The euro has experienced a similar episode recently. This situation seems to be about to correct itself, now that more and more signs point to a closing of the growth gap between the United States and continental Europe.

Thus, the potential appreciation of the euro is more than ever a topical question. This potential clearly reflects the economic soundness, dynamism and strengths of the euro area, supported by the structural reforms under way. As these winning cards, if I may say so, are now materializing more and more clearly, I am confident that market participants will soon share our analysis.