Jürgen Stark: German financial markets - meeting the challenge

Speech by Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, at the Euromoney Conference, held in Frankfurt, on 19 September 2000.

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It was the Greek philosopher Heraclitus who said *panta rhei* - that everything is in flux, like a river. No one steps into the same river twice. All things are subject to change and in constant flow. But it makes a very big difference which river you step into - the gently flowing Main-river, for example, or the headwaters of the Rhine-river. As far as the financial markets are concerned, there is much to indicate that we are caught up in a raging mountain river which is digging a new bed after heavy thundery rain.

During the past few years, individuals, enterprises, markets, institutions and governments have been up against a raging current of change in the conditions under which they operate. Remaining passive in the face of such a development is fatal. It is imperative to take an active role in shaping those conditions or, at least, to look ahead and adapt to the given circumstances.

In this situation, it is the primary task of the legislature to set the underlying statutory and regulatory conditions which enable legal certainty, equal opportunity and competition to prevail on the markets - not just nationally, but internationally too. Examples of this to be cited for Germany are the implementation of EC directives on capital market liberalisation, the construction of an efficient securities trading supervision, the planned extensive reform of legislation governing stock exchange transactions and - probably of greatest significance at the moment - the recent tax reform.

It is up to market organisers and market players to create efficient market structures and offer products that hold out the promise of sustained profits within the given statutory framework in line with the pursuit of their individual business. Instances of this are the emergence of new stock markets and stock market segments, and the creation of a large number of derivative instruments.

Following the establishment of the European Central Bank (ECB), the Bundesbank is now an integral part of the European System of Central Banks (ESCB). The Bundesbank participates in the performance of the ESCB's tasks with the primary objective of maintaining price stability, and arranges for the execution of domestic and international payments. Price stability and a functionally viable financial market structure are the preconditions which permanently have to be ensured so that there can be efficiency in financial transactions. In turn, efficient financial markets are the indispensable medium for a predictable and rapid transmission of monetary policy measures. Seen in that light, monetary policy and efficient financial markets are in a symbiotic relationship.

Although the Bundesbank cannot, on regulatory grounds, take on the role of moderator - or even promoter - for the financial centre that some market players would like, it is, in fact, always ready to give active support as an advisor and initiator. The modernisation of German debt management or the customer-friendly ECB minimum reserve arrangements are illustrations of that. The fact that monetary policy has been transferred to the European Central Bank allows the Bundesbank to attend more than before to the continued strengthening of the competitiveness of the financial markets in Germany.

A radical transformation is taking place in the financial sector, driven by the "mega trends" of globalisation, deregulation, innovation and the use of new technologies. In this connection, the trend has been strengthened by the introduction of the single currency in Europe. Securitisation was already one of the dominant trends in the early and mid-nineties. The adoption of the euro has now brought about a further surge in securitisation and given an additional boost to disintermediation. For the German credit institutions, the euro means that they no longer have the competitive advantage of the D-Mark, whereas for others it means that they no longer face the "D-Mark home currency" barrier to entering the market. Competition is becoming more and more intense within Europe and globally. Increasingly, credit institutions not only have to withstand growing competition from other banks but are also competing to a greater extent with insurance enterprises, investment and pension funds as well as online brokers - in some cases even from within their own groups.

The response to such developments can basically be either consolidation or specialisation. Consolidation - even if only at the national level - is not an easy undertaking. The past failed attempts of the big German banks to merge in a range of combinations illustrate how difficult it is to bring together different corporate cultures and strategies. It may be that the favourable tax treatment of capital gains from the sale of domestic participating interests from 2002 will provide new impetus for mergers. Another possibility is cross-border consolidation in Europe with the involvement of German institutions. However, irrespective of the Common Market and EMU national interests have often stood in the way of cross-border activities. It is also often argued in this context that, because of the comparatively strong competition as a result of the density of banks' branches, the majority of German credit institutions are generally - but especially in retail banking - not profitable enough. To counter such criticism and create the conditions for cross-border consolidation, further streamlining of the branch network and the increased use of new technologies therefore seem inevitable.

The introduction of the euro created the essential precondition for the development of a large supranational euro capital market. The fragmentation into national capital markets - particularly bond markets - which was essentially due to the existence of different currencies and the resulting interest-rate differentials, can admittedly still be felt. But, under the influence of competition, the previously national markets are increasingly merging and gradually losing their special features. The immediate conversion of government issues into euro and the large degree of harmonisation in market conventions have played a major part in the market becoming more homogeneous.

For a variety of reasons, the emergence of a completely uniform European bond market will scarcely be possible. Despite a greater degree of coordination, the fiscal, economic and social policies of the participating countries will, for the present, remain a national responsibility.

That is likewise true of government debt management with its significant repercussions for the capital markets. Differences in financial standing, liquidity and issuing procedures, and the varying efficiency with which the cash, futures and repo markets interact in the individual countries will ensure yield differentials in the case of issuers and issues in the medium term as well.

In that respect, the Federal Government is in a favourable position. Even after losing the competitive advantage of the D-Mark, it has remained the benchmark issuer and is able to borrow at the comparatively lowest cost. For that reason, the Federal Government - quite apart from the fundamental legal reservations against a communitisation of debt management - should hardly be interested in communitised borrowing under the umbrella of a European debt agency. As experience of the German *Länderjumbos* shows, its financing costs might tend to rise. What should also not be overlooked is the fact that competition among the individual countries for the lowest possible financing costs has a healthy influence on budgetary policy and the efficiency of issuing policy.

If the debt agency that is planned by the Federal Minister of Finance does come about - despite many reservations, not least on part of the Bundesbank - I hope it will be able to maintain or even build on the present strong position of the Federal Government as an issuer. The Bundesbank is ready to work together with the debt agency, to bring its expertise to bear and, in particular, to provide all the operational banking services for it. This would also signal to the markets that setting up the debt agency does not imply any abrupt paradigm change in debt management. That applies especially to any apparently politically motivated stronger short-term orientation in borrowing.

Non-government issuers, too, have successfully adapted to the new underlying conditions. Mortgage banks regularly put "jumbo mortgage bonds" on the market, and place them successfully with foreign investors as well. The issuers are thereby making use of the fact that institutional investors in Europe are gearing their portfolios more and more to euro-area-wide investment. "Exporting" mortgage bonds means that the idea of long-term fixed-rate real estate financing is also being exported. I believe this to be a good thing since it promotes the stability of the financial system in Europe.

Despite several signs of becoming more popular, domestically issued corporate bonds continue to lead a somewhat neglected existence in Germany. Above all, because one-half of paid interest on permanent debts is included in trade earnings, German enterprises are prompted to issue bonds through foreign financing vehicles. Abolishing that regulation would be desirable but would probably be realistic only in connection with the abolition or reorganisation of trade tax as such.

Overall, the "corporate bonds" sector is growing sharply in Germany - as it is throughout the euro area. Lower government deficits - which are made possible by higher tax revenues, the auctioning of mobile telecommunications licences, privatisations as well as a consistent course of limiting expenditure, are creating scope for corporate financing through the bond market. Institutional investors appreciate the enhanced opportunities of portfolio diversification, which bring with them not only higher yields but also greater risks.

There has been a clear improvement in the "share culture" in Germany over the past few years. Large, broadly spread issues, such as those of Telekom or of t-online, have played a part in that in the same way as the extremely successful development of the "Neuer Markt" as a new stock market segment for young high-growth enterprises. The frequent claim that German investors are risk-shy and prefer fixed-yield paper has been emphatically refuted over the past few years. The - in some cases - meteoric price increases on the "Neuer Markt" have, if anything, given rise to the fear of widespread euphoria leading to a lack of discernment. The more reflective mood that has now set in is only to be welcomed in the interests of a favourable market development in the longer term.

The number and market capitalisation of listed German public limited companies have made great advances in the past few years:

- At the end of 1995, 527 enterprises achieved a market value equivalent to €575 billion.
- At the end of 1999, the figure was already 933 enterprises with a market value of €1,426 billion.
- Measured in terms of GDP, market capitalisation is now at 68% compared with 24% at the end of 1995. This means that Germany is still in a lower mid-table position among the industrial countries. There exists potential for further growth.

The European stock market landscape is still distinctly fragmented with a large number of market models, trading and settlement systems. Mergers and close cooperation are inevitable if one wishes to approach the ideal of the perfect market by means of pooling liquidity and lowering transaction costs. The Deutsche Börse AG recognised that fact at an early stage and took the lead in that development. In the "contest of the systems" between "open outcry" and electronic trading in the futures market, it was consistent in opting for the electronic alternative and thus decided the competition for the Bund Future - the capital market contract which currently has the highest turnover - in its own favour.

Generally, it seems that the triumphant progress of electronic trading systems - whether it be stock exchange or OTC trading - is irresistible. Not being bound to a single location, transparency and low transaction costs are major advantages.

Not all Deutsche Börse AG's plans and projects have been realised. Who ventures much will also lose sometimes. But who ventures nothing will never gain. As someone said in a recent discussion with German banks: "There are no failed experiments. There are only experiments with unexpected outcomes."

It is not just for monetary policy reasons that the Bundesbank is interested in efficient financial markets and therefore also in efficient trading and settlement systems. As the fiscal agent for the Federal Government, the Bundesbank is also a major market player in on-the-floor bond trading in the stock market and in Xetra bonds. The Federal Government and the Bundesbank have been following Deutsche Börse AG's plans for Eurex bonds as a successor system for Xetra bonds from the outset and, a few weeks ago, decided on active participation. The Federal Government and the Bundesbank have declared their expectation that the system will be open to a wide range of participants. In this connection, I hope that Deutsche Börse AG soon succeeds in the intended linking of the cash, futures and repo markets and that it can successfully hold its own in competition with other electronic bond trading systems.

Germany sometimes has difficulties with reforms. In a federally structured state with numerous strong interest groups, that comes as no surprise. It is therefore all the more gratifying to state that - despite all the criticism of specific points - a tax reform has been initiated which deserves the name. The tax reform will bring about a crucial improvement in the conditions for economic activity in Germany. It will mean a considerable easing of the burden on enterprises and households and create planning certainty for the medium term. The fact that capital gains from sales of domestic participating interests are to be exempt from tax in the case of incorporated enterprises will make the - in some cases - overdue restructuring of German groups much easier. With the lowering of corporate tax rates, Germany will in future occupy a competitive mid-table position in international terms.

What is a problem, however, is that the reform will create further competitive distortions owing to retained profits being given preferential treatment over the distribution of dividends by incorporated enterprises, and other sources of taxable income. This will weaken the steering function of the capital markets. What will prove to be a particular drawback for the financial centre Frankfurt is the planned tax prohibition on offsetting losses arising from share derivatives against profits from the underlying shares. Here, a better solution should be found. Another justifiable point of criticism is the continued failure even to make a start on simplifying the highly complex German tax system. Tax consultancy is still going to be a growth industry in Germany.

Despite all the satisfaction about tax relief measures, we should not overlook the fact that the tax burden will still be quite high in Germany, which means that Germany has to maintain a consistent course of fiscal consolidation. Excluding the receipts from the mobile telecommunications licences, the fiscal balance in 2000 will show only a slight improvement despite much higher tax revenues. In the coming year, the structural deficit will increase significantly. In other words: further reductions in expenditure are required in order to create scope for lower taxes.

Maintaining and enhancing Germany’s overall competitiveness - and certainly not just the competitiveness of its financial markets - is an ongoing task. International investors are looking to how Germany, as Europe’s largest economy, copes with changed underlying conditions. Much has already occurred or been set in motion in Germany, such as the privatisation of former public enterprises together with market liberalisation and deregulation in such important areas as telecommunications and the post services, or price liberalisation in electricity.

What still has to be done is the reorganisation of our social systems in line with foreseeable demographic developments. The basic features of the statutory pension scheme reform presented by the Federal Government would contribute to distributing the demographically induced burdens more equally between the present and future generations of pensioners, but consideration should continue to be given to raising the actual retirement age. The envisaged capital-backed supplementary pension would also place the funding of old-age provision on a broader foundation.

What is also needed is to make our labour markets more flexible with the aim of reducing unemployment, which is still very high. That would also be an essential condition for bringing down non-wage labour costs - which are extremely high by international standards - in a systemically appropriate manner.

Regrettably, the reforms that have already been implemented or are planned in Germany as well as in other European countries have received scant attention up to now outside of Europe. The markets obviously lean towards an asymmetrical view of things, with matching consequences for the external value of the euro.

In conclusion, I would like to say a few words on our own behalf. The establishment of the ECB has created a new level of decision-making in the monetary policy of the countries in the euro area. The Bundesbank is now part of the European System of Central Banks (ESCB). This means that the Central Bank Council no longer has the power to decide monetary policy.

What is necessary under the new conditions is to have a uniform management body located in Frankfurt. This would mean that the provision of Bundesbank services to the regions is not jeopardised.

The independence of the ECB and of the national central banks within the ESCB is a key feature of European monetary policy. The “denationalisation” which this achieved was desired by all of member states and explicitly recognised by the signing of the Maastricht Treaty, which was unanimously approved by the second chamber of the German parliament representing the *Länder* or regions, the *Bundesrat*. Monetary policy can only be “denationalised”, however, if national aspects no longer play a role in the assessment of monetary policy. That applies all the more to specific regional aspects.

The Bundesbank is ready to adjust. During the past few weeks and months, the President of the Bundesbank has repeatedly pushed for the necessary measures of reform. As a member of the ECB Governing Council, he is aware of what kind of reforms are needed. That is not so in the case of proposals that have recently been put forward elsewhere, which, by contrast, appear to be short of the basic information about how the ESCB operates. Tackling the reform of the Bundesbank now with all speed and setting a clear course is something that undoubtedly requires political courage. The Bundesbank’s ability to reform - something which the Bundesbank itself desires - is, however, indicative of the “reform-ability” of Germany as a whole. This, in turn, lies in the hands of the politicians. We are waiting for good and forward looking political decisions.