Hermann Remsperger: Euro markets in a global context

Speech by Professor Hermann Remsperger, Member of the Directorate of the Deutsche Bundesbank, at the Gulf Euro Summit, held in Dubai, on 8 October 2000.

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I

European economic and monetary union (EMU) has brought about important changes in the framework for financial markets. This is particularly true of the 11 European countries which have merged their national currencies into a single currency, the euro, and which have been conducting a common monetary policy since 1999. However, these changes also apply to market participants in other countries which maintain economic and financial relations with the countries participating in EMU. They, too, no longer have to deal with different EMU currencies but only with a single one. Thus, non-participating states have increasingly perceived the EMU countries as a single area.

Let me start by saying that the euro area represents a relatively large economy. In economic terms, the euro area comes close to the size of the United States; both economic areas are far larger than Japan. Measured in terms of world GDP, the US share is about 20.8%. The share of the euro area amounts to 15.5%. It is significantly larger than that of Japan (7.4%). The population of the euro area, at around 290 million, is larger than that of the United States (270 million) and of Japan (125 million).

The size and capacity of an economic area is of significant relevance to its currency and to the evolution of its financial markets: economies of scale play an important role, especially in determining the degree to which the money is used. A large economic area generates a large "natural constituency" for its own currency. If a currency is widely accepted, this normally lowers transaction costs, thus attracting international customers and spreading the currency even farther beyond its domestic area.

The argument of size is all the more important since the euro area is highly integrated into the world economy. The euro area accounts for one-fifth of world trade, excluding trade within the euro area. This is more than the corresponding ratio for the United States, which is 15%, or Japan, which is just under 9%.[1]

II

If the three large economic regions are examined with respect to their different financing structures then it quickly becomes apparent that loan-based financing via the banking sector is still important for the euro area. The volume of credit which euro-area monetary financial institutions have granted to resident enterprises is, at over 100% of the euro area's GDP, twice as high as the corresponding figure for the United States (47.5%). In Japan, bank loans, which amount to 92% of GDP, also play a relatively important role in the financing operations between different economic sectors.[2]

By contrast, the US economy may be described as a *securitised economy*; much of the financing is done not through the banking system but directly on the securities markets. At the end of 1999 *outstanding domestic debt securities* in the United States were valued at over US$ 15,000 billion, or 161% of GDP. In the euro area they came to around 90% of GDP and in Japan to 131%, although in

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[1] For the source of these figures, see ECB, *The euro area one year after the introduction of the euro: key characteristics and changes in the financial structure*, Monthly Bulletin, January 2000, pp 35-49.

[2] For more on this see also OECD Financial Market Trends No 76, July 2000, *Main Changes in the Financial Structure of the Euro-Zone since the Introduction of the Euro,* pp 109-127.

the latter case it should be borne in mind that many of the debt securities were issued by the public sector.

It is also interesting to observe the amount of financing which companies obtain on the capital market. Whereas euro-area corporates have issued debt securities amounting to only 3.5% of GDP, the corresponding ratio for Japan is four times as high and for the United States eight times as high. The figures for equity market capitalisation confirm the initial impression that the securitisation of lending has an upward potential in the euro area. Expressed as a percentage of GDP, market capitalisation in the euro area is only about half as large as that in the United States or in Japan.

However, while it is true that the financial system in the euro area is still more oriented towards the banking industry, bond and equity markets have already begun to play a bigger role. There is also reason to believe that the presumed dominance of bank loans has been exaggerated and the degree of equity financing correspondingly underestimated. New data for Germany show that at the end of 1998 the volume of bank loans to non-financial companies exceeded equity financing by a mere 5.3%. In addition, the aforementioned figures provide only a snapshot at a certain point of time and, as such, do not reflect changes in their status.

As far as the euro area, in particular, is concerned, the introduction of a single currency has contributed to a process of adjustment, which tends to promote the securitisation of corporate financing. Thus the volume of corporate bonds outstanding in the euro area has increased by approximately one quarter since the start of EMU. This segment of the euro-area capital market, which started off on a small scale, now presents one of the highest growth rates.[3]

Meanwhile, the banking sector remains engaged in a process of consolidation, as it has been for some time now. In 1999 the number of monetary financial institutions in the euro area declined by around 5%. The introduction of the euro, together with technological innovations and the deregulation, liberalisation and globalisation of financial markets, have led to even fiercer competition among the banks.

An increasing shift from traditional forms of banking intermediation towards the securitisation of assets and liabilities does not mean that the "Anglo-Saxon market-oriented model" of a financial system is principally superior to a bank-oriented system. Both systems have their inherent advantages and drawbacks. This is why the financial system in a particular economy is not based exclusively on one model or the other. Only the extent to which one financing alternative is preferred to others differs from one economy to the next. Even so, it seems to me that the relative advantages also change over time, depending on the underlying economic and financial conditions. This appears to be precisely what is happening now in the euro area.

III

The changes on the euro financial markets would seem to suggest - at least at first glance - that national markets are now converging to form a single market. I would argue, however, that this has occurred to varying degrees in different market segments.

The greatest degree of integration has been achieved in the euro money market, and within this area it is best exemplified by uncollateralised inter-bank deposits:[4] here the interest-rate differential between individual euro-area countries is minimal. Cross-border transactions already account for more than one-half of money market operations. And trade volumes have risen significantly, compared with the period prior to monetary union.

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[3] According to data released by the ECB, only the issues of "non-monetary financial corporations" are growing at a faster rate at the present time, having increased at a rate of around 48% up to the end of June 2000.

[4] See Javier Santillán, Marc Bayle and Christian Thygesen, *Impact of the Euro on Money and Bond Markets*, ECB Occasional Paper Series No 1, July 2000.

It was extremely important for the success of monetary policy in the Eurosystem that a single money market was established right after the introduction of the euro. Only a well-developed money market is capable of ensuring a smooth distribution of liquidity across the euro area and the efficient transmission of monetary policy impulses.

The euro bond markets have become "larger" and grown closer together. In order to survive the more intense competition within the euro area, major issuers (especially the national governments) are attempting to redesign their debt securities to make them as attractive as possible to potential investors. Thus some euro-area countries have begun to concentrate their issues on specific maturities in order to increase their liquidity and achieve benchmark status in certain market segments.

Investors have also adapted quickly to the new market conditions and - if the figures for Germany are any indication - have invested heavily in the bonds of other euro-area countries. As a result, the interest-rate differentials for euro-area government bonds have narrowed appreciably. The remaining small spreads are largely due to differences in liquidity.

The progress that has already been made does not, however, detract from the fact that differences in the legal systems and settlement systems stand in the way of a more far-reaching integration of the bond and equity markets. In comparison with the United States, for example, they give rise to unnecessary transaction costs. Estimates suggest that a better market infrastructure could reduce the settlement costs involved in cross-border securities transactions so much that they would then be at a level comparable to that of domestic transactions.

IV

Now I would like to talk about the euro's role among the other major international currencies. Here it is important to distinguish between two separate issues: the market shares which the euro has captured as an investment and reserve currency and the movements in the euro's exchange rate.

While it is true that the euro is a new currency, it was able to benefit from the world-wide acceptance of mainly the DM. This is especially evident in the size of its market shares. The euro is the second most important international investment and reserve currency, after the dollar, and its market shares far exceed those of the yen.

Around one-quarter of cross-border bank positions are denominated in euro. The corresponding shares of the US dollar and the yen amount to somewhat more than 40% and just under 10%, respectively.[5] The euro accounts for 30% of the international debt securities outstanding, the US dollar for 48% and the yen for 10%. If new business alone is taken into account, the euro, since its introduction, has more or less kept pace with the dollar. If this trend continues, the shares which the euro and the dollar have in the world-wide market for debt securities outstanding will also converge over the longer term.

The euro's growing importance on the international financial markets contrasted sharply with its exchange-rate movements. How could the euro gain market shares on the international financial markets while losing so much of its value? First, it must be borne in mind that the euro as an issue currency has benefited from low interest rates. Together with a generally falling euro exchange rate, the low interest rates for the euro, have served to attract issuers from all over the world.

A look at the past may prove helpful in providing a second explanation. The dollar has always been able to maintain its position as the leading world currency despite the ups and downs in the dollar exchange rate. Apparently, the individual currencies' positions on the international financial markets are determined, at least to some extent, by factors other than the exchange rates.

Looking for possible causes for the recent weakness of the euro, it will soon become apparent that the euro's exchange rate reacted asymmetrically to macroeconomic events on each side of the Atlantic.

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5 The figures given for these shares are based on data, which the BIS regularly publishes in its Quarterly Review. See BIS, *International Banking and Financial Market Developments*, August 2000.

Thus, the successful passage of the tax reform bill in Germany was barely acknowledged in exchange rate movements while the surprisingly large growth in US GDP in the second quarter was reflected rather quickly in a corresponding fall in the euro exchange rate. Apparently, the uncertainties associated with the euro area received more attention than those affecting the US economy.

Exchange rates do not, however, consistently move in only one direction. Cyclical developments may revive the diversification argument as a strategic consideration. Moreover, empirical studies support the view that the composition of foreign exchange reserves to some extent reflects the structure of external trade and financial ties. If the euro were to become more popular among private market participants, it might also significantly improve its fortunes as a reserve currency.

The role that the euro has so far played as a reserve currency has been rather modest. Although it also occupies second place in this segment after the dollar, the gap between the two is large. IMF estimates have set the volume of foreign reserves held in euro at the end of 1999 at 12.5%, compared with a US dollar share of 66.2% and a yen share of 5.1%.[6] However, one could argue that the euro has held up well in comparison with its predecessor currencies.

V

At this point, allow me to summarise while at the same time casting a glance towards the future. With the introduction of the euro, the balance of forces within the international financial system has shifted. A second currency now exists alongside the dollar which - given the size and economic strength of the euro area's financial markets - has the potential to become a significant currency with global status. The extent to which the euro will actually realise this potential also depends on political decisions taken within the euro area and on the confidence which market participants world-wide place in the new currency.

Thus the first priority must be to guarantee the internal stability of the euro. This constitutes the primary objective of the Eurosystem, which has already reacted to imminent inflation risks with several interest-rate increases. However, economic and fiscal policy makers, who are capable of accelerating economic momentum in the euro area through the appropriate structural reforms, are also called upon to act. Much has already been undertaken or set in motion, as in the case of taxation policy. However, the markets have not (yet) rewarded these efforts.

Important policy initiatives still have to be introduced in the financial markets as well. The introduction of the euro has succeeded in ending the segmentation into different national currency zones and in intensifying the competition in individual market areas. Some obstacles to the integration process only really became apparent once this had been achieved. If one is truly to speak of uniform financial markets in the euro area, priorities for the future will have to include further improvements in the infrastructure of the equity and bond markets and a standardisation of legal and administrative frameworks. Transaction costs between two euro-area countries should not entail higher costs than those of purely domestic transactions. Moreover, transaction costs within the euro area must not be higher than the international standard, if the euro is to prosper in international competition with other currencies.

Let me conclude by emphasising that the financial market trends in the euro area should also be seen in the light of the developments in the "real" sector of the economy. The financial system not only has to accommodate the changes in the real sector but it also has to support them. In my view, innovative financial services - either provided by banks or directly by markets - play a key role in creating a "New Economy". In this context banks and insurance companies are sometimes portrayed as a part of the old economy whereas venture capital firms are mentioned as a driving force for a new economy. It is my opinion, however, that this division between old and new is rather artificial. In Germany last year 56% of the funds of venture capital investment companies was provided by banks and insurance

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6 See IMF, *Annual Report 2000*, Table I.2.

companies. Seen in a global context I do believe that the market for venture capital has a big potential for growth in the euro-area. With this positive outlook on a very special and very important segment of euro-financial markets I'd like to finish my presentation.