Ernst Welteke: Trends in international banking

Address by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the International Arab Banking Summit held in Frankfurt, 19 June 2001.

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Ladies and Gentlemen,

I would like to welcome you to the International Arab Banking Summit 2001 in Frankfurt, the City of the Euro. Frankfurt is home not only to the Bundesbank and the European Central Bank but also to as many as 340 banks, including more than 130 foreign banks. It is the leading financial centre in Germany and the euro area.

The heart of the Eurosystem is the right place to discuss trends in international banking, such as electronic banking, as well as questions regarding a deepening of the Euro-Arab partnership.

I

The success of the common currency in the European Monetary Union has rung in a new phase of debate about monetary unions. This holds for all continents, for North and South America, for Asia as well as the Arab countries. The decision to adopt further steps leading towards a common monetary union by the Gulf Cooperation Council at the end of last year attracted a lot of attention.

Clearly, the process of integrating different economies is an arduous one, involving not only the surrendering of a national monetary policy but also a process of integrating the real economy.

In Europe this process took almost half a century, from the first pro-European declaration to the full integration of monetary policy in the European monetary union. Harmonising tariffs and creating a single European Market with free movement of goods, services, capital and labour created the basis for a common monetary policy. In addition the convergence process caused macroeconomic policy and data to converge to such an extent that the abolition of national monetary policy would no longer cause major distortions.

The Arab countries face similar problems in terms of tariffs and trade barriers. Clearly, the basis for a common monetary policy is a single market for the real economy, the financial system and labour markets. Even within the Gulf Cooperation Council (GCC) there is still a long way to go.

There are, however, some encouraging characteristics in the GCC for integration. The similarity of the economies is a striking feature. All depend to a large extent on energy exports. The price of crude oil is by far the single most important factor determining the business cycle. In addition to the similar sectoral structure of the economies the common language represents an integrating element. The same holds true for the common culture, religion and the similar geography.

To reach the goal of an Arab Monetary Union, particularism has to be overcome, and factors promoting integration have to be supported. Overcoming particularism would foster communication within the region and with partners in other regions.

All Arab countries are endeavouring to develop their economies towards a more balanced structure. This ongoing modernisation in many Arab countries offers chances for the Arab countries and the rest of the world alike. Sectoral diversification forms the basis for growing intra-regional trade. It will reduce reliance on energy exports and create a more self-sustaining Arab economy. The world economy would clearly benefit from Arab industry playing a more lively and active role.

Strengthening the domestic financial sector in Arab countries seems to me to be a necessary step in this direction. The quick adoption of modern instruments like electronic banking and the coming revival of the important financial centre in the 60s and 70s – Beirut – are only two examples of promising developments in this region's financial markets.

The Arab banking sector has successfully embarked on the current global trends in this industry. Based on its generally sound profitability it meets the challenges of globalisation, concentration and electronisation.

Modernization and diversification of the real economy will cause the need for banks to deal with the demand and risks of non-oil-business. The dependence of the whole economy on the price of oil will decrease, and so will the dependence of the financial sector. As a compensation a greater diversified economy provides for an easier risk distribution. In addition, liberalization, a more competitive environment and the trend towards lesser state control will require a more active role of bankers.

I have no doubt that the Arab banks will prove their success in dealing with a changing environment and in reorganizing their business. They have impressively proven their creativity in dealing with the growing field of islamic banking. Maybe western banks can learn from this field for the growing venture capital markets.

Another challenge for Arab banks is electronic banking. However, the late but very quick adoption of internet banking and the high acceptance of this new medium provide for a good starting point.

The European experience on electronic banking in a nutshell is: Banks will become “bricks and clicks banks”. Many services can be digitalized and provided electronically, but not all. The combination of digital and personal services seems to be the successful strategy at present.

The overall outlook for Arab banks hinges on the overall economic perspectives. These give rise to hope. Growth is picking up, inflation rates are kept relatively low and modernization of the economic structure is proposed by leading businessmen and politicians. This will be supported by the relatively “young” population – in many Arab countries more than 50 per cent of the population are younger than 20. This in itself provides for a rising competiveness and creativity in the economy.

II

Having this in mind Europe may be of special interest for Arab countries for two reasons: First, as a potential partner for economic cooperation and second, as an example of successful integration.

The main development for financial markets in Europe has been the launch of a new currency, the Euro. The financial sector in Europe benefits to a large extent from the monetary union and the evolution of a single European financial market. That implies greater transparency, more competition and more liquidity.

Germany as a financial centre benefits from this – in everyone’s interests. Functioning, liquid and sound financial markets steer capital towards those areas of the real economy where it brings the highest yield. In this way, they contribute to improving welfare, strengthen the economy and create jobs.

The ECB, as a constituent part and the centre of the European System of Central Banks, is domiciled here in Frankfurt. This has positive implications for Germany as a financial centre. It does strengthen the self-confidence of the credit institutions located in Frankfurt, and – at least every fortnight – it draws the attention to Frankfurt when the meetings of the Governing Council of the European Central Bank take place. This is where European monetary policy decisions are taken.

The direct advantages of the monetary union are increasingly being appreciated. It is no longer possible for exchange-rate fluctuations to distort competition. There is no longer a need for the economy to engage in hedging activities in cross-border trade and foreign direct investment. Transaction costs in the markets have diminished, and prices are directly comparable.

These are advantages not only for the economy, but also for every citizen – advantages which make themselves felt for every transaction, every trading operation, every trip abroad.

The question arises as to whether the introduction of the single currency has led to the development of a single, enlarged European financial market. It is precisely in this area that much was expected from the euro – when compared with the US financial market.

Regarding the money market, these expectations have undisputedly been met. The individual national money markets in the euro area have rapidly combined to form a single euro money market.

The capital markets are changing somewhat more slowly. On the capital markets the euro is not the only factor promoting change. The trends towards globalisation and deregulation as well as new developments in technology are also playing a major role. The markets have become more liquid, larger, deeper and more complex.

It is true that on the way towards a single European capital market more work has to be done. Institutional, technical and legal barriers are hampering the process of integration. The fact that there is no single sovereign issuer, but rather 12 different government issuers, undoubtedly contributes to the certain degree of fragmentation that still exists. In this context, the benchmark position of the German Bund is something of which we can be particularly proud. The great diversity of issuers will, for the time being, remain a characteristic feature of the European capital market.

The same is true for the large number of stock exchanges and exchange-like trading systems as well as the different clearing and securities settlement systems. This does not, however, rule out the possibility that the individual capital markets will become progressively closer to each other in terms of their economic organisation. This is something the institutional investors themselves are already taking care of.

There are many signs that a more market-oriented financing structure is evolving in the euro area. Enterprises are increasingly meeting their financing needs directly through the capital markets, that is: by means of negotiable paper.

The dynamism of this disintermediation process may be gauged by the development of the equity market: the degree of market capitalisation has increased significantly. This is a reflection not only of higher equity prices but also of the steadily rising total number of enterprises listed on the stock exchange.

A major contribution to this development has been made by the *Neuer Markt* (new market) of the Frankfurt stock exchange. This is where young, innovative enterprises obtain access to risk capital. In terms of the *Neuer Markt*, Germany has the top position among European growth markets – even if some investors may have overlooked the fact that this is a market for risk capital.

In addition, the market for corporate bonds is on the advance. Alongside the introduction of the euro itself, a major driving force has been the continuing restructuring of the corporate landscape.

However, changes are not restricted to the financial markets themselves. The entire financial sector, including the whole range of financial intermediaries and financial institutions, is affected by them. As a result of the loss of the “home-field advantage” represented by the Deutsche Mark, at the start of monetary union the German credit institutions entered into competition with all the other banks in the euro area. All of them are now selling the same basic product: in other words, the euro. Besides that, credit institutions are faced with increasing competition from direct banks, online brokers, insurance companies, free investment companies, and so on.

Possible responses to the new competitive situation are either consolidation – including hostile takeovers – or specialisation. As we have had to learn from some examples from the recent past, the merging of long-established banks is not an easy undertaking: at the time when the mergers are to be implemented, at the latest, there is a clash of different corporate cultures, and problems could emerge. This applies all the more in the case of cross-border mergers.

At present, consolidation in the financial sector is taking place mainly at the national level. However, the situation may well change in the future. The euro has the effect of promoting competition. It ensures transparency and makes comparisons within the euro area easier.

Those involved in the legislative process in Germany are nowadays aware that the underlying statutory and regulatory conditions are crucial to a financial centre’s success. Since the early nineties, the German legislature has passed three special acts for promoting the financial market. A fourth is to enter into force in this legislative period. So far, the main points of emphasis of the legislation have been the reorganisation of stock exchange supervision and the establishment of the Federal Supervisory Office for Securities Trading here in Frankfurt. In particular, the Securities Trading Act provides the Federal Supervisory Office for Securities Trading with instruments for investigating insider offences.

The Fourth Financial Market Promotion Act is intended to strengthen further the integrity of the financial markets and broaden the scope of action available to stock exchanges and investment companies.

The supervisory system for financial markets in Germany and some other European countries is reformed to meet the challenges of globalisation and securitisation. In addition the trend towards a more capital market orientation will be met by the requirements for banking supervision as set up in the Basle II agreement.

Overall, the financial sector in Europe and Germany as a financial centre are well equipped to face the challenges and make use of the opportunities that the euro presents.

Moreover the European Monetary Union has led to a region of stability unprecedented in European history. Currently, the area of stable money goes from the Atlantic Ocean to the Aegean Sea, and from the Strait of Gibraltar to the Arctic Ocean.

Inflation as well as interest rates have gone down to levels hitherto unexperienced in many participating countries. Growth and stability in the euro area will be promoted by the common currency. Many changes in the political and structural conditions in Europe are yet to come. Europe is a region departing for more integration and a brighter future. This makes it particular attractive for potential partners.

III

The long history of fruitful European-Arab partnership leaves us with a unique legacy and forms a basis for us today to revive our commercial, cultural and political links. Especially the traditionally good German – Arab relations of the past are a call to improve the current cooperation between these two regions. 300 million Europeans and about 350 million Arabs, including all people in the Middle East, need to cooperate closely. A united Europe may include east and south-east European states within the foreseeable future. By then, the Middle East would be a direct neighbour of the euro area. Clearly, good neighbourly relations – marked by peace, fairness and much closer economic interrelationships than today – should be in the interests of both regions.

Both regions have a lot to offer. The Arab region is still gaining in importance for international stability and energy supply. Its large role in international finance, not only by the recycling of petrodollars, is being acknowledged. Within a couple of years the Arab countries will probably also be better represented in international organisations and better integrated in world politics and the global economy.

I do know that the European Union is seen as a highly instrumental – or even natural – partner in the process of modernisation which Arab countries are undergoing at present. Therefore, the process of cultural and economic convergence between these two regions should be accelerated. Economic and technological integration, cultural respect and political necessity have been identified as its characteristics.

Conferences like this offer a great opportunity to enhance mutual understanding. May this conference also pave the way for mutual beneficial cooperation.