Ernst Welteke: The euro changes Europe and the world

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, to the Japanese Bankers' Association, Tokyo, 28 November 2001.

*   *   *

I

Ladies and Gentlemen,

First of all, I would like to thank you most sincerely for your kind invitation to speak to such a distinguished audience. It is always a pleasure for me to be here in Tokyo. I especially appreciate the opportunity to discuss with the financial elite of Japan the changes brought about by the introduction of the euro. Thank you very much.

The European monetary union is only 33 days from completion. On January 1st, the notes and coins of the single European currency will be circulated. Europeans will be able to pay bills using their domestic currency in all twelve member states of the Eurosystem. For the man in the street, this is a sea-change. In economic terms, however, the cash changeover is virtually a non-event. Europe has de facto had a common currency and a single monetary policy for nearly three years now.

The EU has been developing a common market for more than half a century. However, the member states of this closely-knit economic network have (almost) all used a currency of their own. In 1999, economic and financial integration made a huge leap forward, as eleven – now that Greece has joined, twelve – countries decided to embark on a common currency.

II

What is this strange Europe like, that wakes up only when the business day in Japan is well advanced?

Let me start with a few figures. The euro area has a population of 300 million people – quite similar to the United States. The twelve countries have twelve national governments. People in the euro area speak eleven native languages.

The euro area is the most open of the three large currency areas – the United States, Japan and Europe. Japan and the United States are our most important non-European trading partners. 17 percent of our six and a half billion euro GDP is generated by exports, and the current account is roughly in balance. Average per capita GDP stands at somewhat more than € 20,000 (roughly Y 2.2 million), a third less than in Japan. Differences between countries are considerable.

The public sector share in the euro-area economy accounts for nearly fifty percent of GDP, and the aggregate budget shows a small deficit. Aggregate gross public sector debt stands at 70 percent of GDP. Individual country figures, however, differ. For instance, gross public sector debt ranges from four percent of GDP (Luxembourg) to 100 percent of GDP (Belgium, Italy).

Heterogeneity is a fact of life in the euro area. But homogeneity far outweighs heterogeneity in one crucial respect: we are united by our intention to form an integrated Europe with a common market as a strong and reliable partner for the world economy.

III

In addition, our monetary union is built on a host of common values and interests. The euro-area countries share a firm stability orientation. It is reflected in the institutional framework of the European Monetary Union.

The European System of Central Banks is a two-tier system. It consists of the national central banks and the European Central Bank, the ECB. Both the ECB and the national central banks are independent from any political interference.

Monetary policy decisions are taken by the ECB Governing Council, which consists of the six-strong ECB Executive Board and the Governors of the participating national central banks. The vote of very single Board member or governor carries the same weight notwithstanding the size of population of his home country. The rule is "one person, one vote". Unlike the centralized decision-making, the implementation of the single monetary policy is decentralized. National central banks provide the markets with liquidity, in accordance with the decisions of the ECB Governing Council.

The primary objective of the European System of Central Banks is to maintain price stability. The ECB Governing Council defines price stability as an increase in consumer prices (measured in terms of the Harmonized Index of Consumer Prices) of less than two percent a year.

The ECB Governing Council has opted for a two-pillar strategy to analyze prospective price movements over the medium term. In pillar one, the growth of a broad monetary aggregate is analyzed. This pillar takes account of the fact that, over the medium or longer term, inflation is always a monetary phenomenon. In pillar two, a wide range of other economic and financial variables indicating potential future price effects, are closely analyzed. The two-pillar strategy makes for a broad assessment of the potential risks to future price stability.

The second stability-ensuring institutional feature of EMU – besides the ESCB – is the Stability and Growth Pact. It spells out how member states are supposed to ensure sound public finances, as the Treaty obliges them to avoid excessive deficits.

Wage policy is another national responsibility. In the most recent years, wage agreements have been settled roughly in line with productivity advances. Since the start of the monetary union inflation expectations have been low and stable. This reflects confidence in the Eurosystem's policy, and helps in negotiating stability-oriented wage settlements.

To sum up:

We have a single currency, the euro. Monetary policy decision-making is centralized, the primary objective of monetary policy being clearly specified: price stability. Stability-oriented monetary policy is underpinned by stability-oriented fiscal policy.

However, even in a watertight institutional and political environment, stability cannot be taken for granted. Stability must be earned, again and again, day by day. The German "Stabilitätskultur" – one may translate this as "stability culture" – is one of our most cherished exports to our European partner countries. European people now share a firm stability orientation.

IV

How did the single monetary policy perform?

At its start, the Eurosystem saw a period of hitherto unprecedented price stability. In 1998 and 1999, consumer prices rose by only 1.1 percent; in the year 2000, the inflation rate, at 2.3 percent, ran a little above the two-percent ceiling, after the sharp increase in oil prices.

This year, after peaking in May, at 3.4 percent, the inflation rate has been decreasing. In October, prices were 2.4 percent higher than a year before. In the current environment of a weak world economy, the ECB Governing Council is expecting a further moderation of price movements. At its meeting on November 8, the Governing Council therefore decided to cut rates by half a percentage point. It has lowered its key interest rates during this year by 150 basis points, to 3.25 percent.

A generally stable currency, and markets that trust the stability-orientation of central banks, make for lower price increases at times of crisis.

In its brief history, the Eurosystem has already dealt successfully with three external shocks and crises. We have witnessed the Asian crisis in 1997-99, an oil-price shock in 1999-2000 and, most recently, the terrorist attacks. Europe did not escape unscathed from all these events. However, the low level of turbulence within the euro area contrasts with sharper reactions to similar events in the period before EMU existed. This means that we have withstood what has been regarded as the worst-case scenario for the new currency. The European currency area exhibits greater macroeconomic stability, to the benefit of all its citizens, and also to the benefit of the world economy at large.

V

The three large currency areas in the world – the United States, Japan and the euro area – together account for almost one-half of world output.

Currently, growth rates are dwindling simultaneously in all three major currency areas. That has very much to do with the higher degree of global integration, still underestimated by many policy makers. Global trade growth will probably slow down to only 1.3 percent this year, after 12 percent last year. The new round of trade talks recently launched in Doha is an encouraging signal in this respect.

Among the major regions of the world, only China, the oil-exporting countries of the Middle East and Russia (including some neighboring countries) will show growth rates of a seriously positive magnitude. There is something like a global business cycle. However, there is no perfect synchronicity among different areas. Causes, consequences and repercussions differ in the three currency areas. This does call for area specific policy responses.

The **US** business cycle is close to a recession. Remember, less than a year ago, forecasters were wondering whether the USA would see a hard or a soft landing. The downward trend of the high-tech industry, and the corresponding overinvestment in IT, were prominent among the causes of the downward movement of growth rates. The savings rate rose abruptly and the labor market performed ever-worse. After September 11, the additional negative psychological impact had to be overcome.

Risk sensitivity initially increased steeply after the terrorist attacks. We have seen a widening of corporate, especially high-yield, spreads over government bonds. The increased risk sensitivity is a major reason why monetary easing has still not made its way through the entire (corporate) yield curve. More recently, the spreads have receded somewhat. They are, however, still above their pre-attack level.

The United States responded quickly to the worsening economic outlook. The Fed lowered interest rates, the federal government substantially reduced taxes. Firms and markets are adjusting quickly. I have no doubt that the US economy will show rising growth rates again within a few months.

Japan — no need to tell you — could not withstand the global downward trend, as the overall economic situation has not been favorable for years. The economy is still recovering from the effects of the prolonged banking crisis that followed the bubble economy of the late eighties.

Finally, the euro-area business cycle followed the global trend more closely than has been manifest in recent years. This can be seen as the outcome of closer links, owing to increased foreign direct and portfolio investment.

Exports and business investment led the slowdown in Europe. Growth rates diminished, employment gains came to a halt, and the prospects for next year have worsened over the past few months. Both business and consumer sentiment are tending to be weak. However, they are still higher than, for instance, during the recession of 1993. So is capacity utilization. Adjustments are taking place and will reinvigorate growth during the next year. As usual, expectations are adjusting faster than production. For Europe, psychological factors are no less important than for any other currency area.

Overall, the political situation in the world today is having a more pronounced impact on the world economy than in less troubled times. The degree of uncertainty is the factor to watch in global short-term economic developments.

European Monetary Union has repeatedly spared us turmoil in the euro area. On the other hand, it has led to tremendous changes within Europe. One of them – and one of vital interest to me – is the changing role of the Bundesbank in Europe.

VI

Among the participating national central banks, the Bundesbank is the one that has seen the greatest changes induced by the changeover to a truly European currency. Before EMU, the Bundesbank had effectively – although not formally – been the central bank deciding the monetary policy for much of Europe. The Deutschmark was the key currency in Europe, and the second most important currency in the world. To this day, the Deutschmark is a byword for stability.

Now the Deutschmark is history, and the German central bank is an integral part of the supranational European System of Central Banks. The Bundesbank has been very active in the process of designing the ESCB. Important features of the system have been modeled on the Bundesbank.

As the German central bank, we have relinquished our outstanding position in Europe. The leading role has been handed over – to the trustworthy hands of the ESCB. Decision-making in European monetary policy is centralized. That constitutes a major change in Europe. As long as the Bundesbank was the leading central bank in Europe, European monetary policy was designed to fit Germany, now it is designed to fit the euro area as a whole.

The Bundesbank contributes its vast experience in the field of economic and financial analysis. Extensive research and analysis have always been a foundation of German monetary policy. The Bundesbank is part of the intellectual infrastructure of Germany and of Europe – and we intend to remain such a "think tank".

In addition, the implementation of monetary policy is entirely in the hands of the national central banks, which deal with the monetary and financial institutions in their home country. Other decentralized functions are:

- The operation of the payment systems, which are interconnected in the TARGET system.
- The distribution of cash.
- The holding and management of currency reserves.

And, it is the national central banks that explain the Eurosystem's monetary policy to the general public in their respective home country.

The role for the Bundesbank has changed tremendously. We have surrendered sovereignty, to become part of a larger system. This was not an easy process, but it was worth the effort.

VII

For the greater macroeconomic stability envisaged by the architects of monetary union to become reality, it is essential for the member states to be convergent economies. A currency union, both stable and beneficial, needs convergence in all three respects: nominal, real and structural convergence.

As regards nominal convergence, inflation rates are the key criterion. The gap in inflation rates – as measured by the standard deviation of EMU country-inflation rates – has been basically unchanged since the launch of EMU.

As regards real convergence, I use the term here in the sense of the synchronicity of business cycles. The Governing Council of the European Central Bank sets a monetary policy appropriate to the euro area as a whole. A country whose business cycle gets grossly out of step might suffer if it is subject to a monetary policy that is inappropriate to its national economy.

However, marching in absolute lockstep is not necessary, as we know from past experience in the United States, where certain regions grow faster than others. The growth rates of states and regions within a currency union may differ to some degree. It is the size of the gap between actual and potential growth rates which matters. If potential output-growth rates differ, actual growth rates may differ as well. That does not necessarily indicate any lack of real convergence.

In the longer run, stability must be built upon economic integration, which brings about structural convergence. An extensive body of theory has evolved on the characteristics of optimum currency areas. The most important feature is that prices and wages must be able to adjust flexibly. The mobility of goods, labor and capital will ensure market integration.

The European single currency has fostered stronger economic integration by means of foreign direct investment. In 1999, world FDI flows, at E 888 billion, were more than three times as high as in 1995. Intra-EU FDI flows grew significantly faster over that period. In 1999, they were five times as big as in 1995. In addition, intra-EU direct investment has risen significantly since the start of EMU. In the year 2000, it actually rose by 50 percent. Today, intra-EU FDI accounts for one-quarter of global FDI.

The FDI statistics show clearly, first, that economic integration in the EU is intense, and, second, that economic integration increased fast after the launch of the single currency. These observations are borne out by the trade statistics. About one-half of the external trade of the euro-area member states is intra-euro-area trade.

VIII

It is in the financial markets that the benefits of a common European currency are to be felt most clearly. The implications of the euro are obvious: rising liquidity, deepening and widening of the money, bond and stock markets, reduction of transaction costs and abolition of currency risks. The euro speeds up financial market integration.

Correspondingly, the functioning of the European Monetary Union depends heavily on a high degree of financial market integration. Its smooth functioning enables monetary transmission to work. Progress in this field is tremendous, but more is yet to come.

Those parts of the European financial markets that are crucial to the transmission of the Eurosystem's monetary policy are already integrated to our satisfaction. The wholesale market for interbank liquidity in the euro area is now actually a single European money market.

In addition, European banks are interconnected in a common payment-system infrastructure. And improvements to the euro-area-wide payment system are being undertaken. A few days ago, the Bundesbank launched its new payment system RTGS^{plus} (Real Time Gross Settlement), which improves security, reduces liquidity needs and expedites settlements of gross payments. Through this system, about 8,500 banks and credit institutions, including their branches all over the world, are accessible.

The most impressive progress, in terms of integration, has been witnessed in the euro-area bond markets. Yield differences among the government bonds of the different participants have narrowed from more than five percentage points before EMU to some 30 basis points nowadays. The remaining spread is mainly due to the varying liquidity of the papers issued. Currency risks or divergent monetary policies no longer disturb the euro-area-wide diversification.

In terms of outstanding amounts, the euro-denominated bond market is still significantly smaller than that denominated in US dollars. But in terms of new issuance, both markets are on a par. One reason for that is the sharp rise in the new issuance of corporate bonds. Here again, diversification within the euro area has increased. The issuers' nationality, as a determinant of the yield and performance of bonds, has been superseded by other factors, especially by a sectoral view.

Accordingly, investors in the equity markets have shifted their perspective from country benchmarks to pan-European sector benchmarks. European equity markets are still small compared with those in the USA. The market capitalisation of domestic shares, as a ratio of GDP, reaches about 90 percent. The matching figures for the USA and Japan are 152 percent and 68 percent, respectively.

Equity markets in the Euro area are growing fast. The ratio of new issuance to market capitalisation averages over 4 percent. This is twice as much as has been achieved in the USA or Japan.

Further integration of equity markets in Europe is being hampered by the segmentation of both stock exchanges and clearing and settlement systems. A consolidation process has started, and should be fostered by legal harmonization in the field of financial services.

The degree of integration in the banking sector is mixed. On the one hand, wholesale markets and investment banking are largely integrated. On the other hand, commercial credits and retail banking still operate in national, segmented markets. However, a few European banks created by cross-border mergers are slowly starting to offer retail services at a standardised level for customers in more than one country.

The financial system in the euro area is still highly bank-dominated. At the end of last year, credit financing totaled about 108 percent of GDP. This is about as much as in Japan, and twice as much as in the USA. The picture is similar with deposits. In the euro area, they account for 80 percent of GDP, and for 110 percent in Japan, while the US figure is only about 40 percent.

However, capital markets are increasing in importance in the euro area. Disintermediation is gaining ground. Financial markets have boomed in recent years and investment banks (as well as non-bank financial firms like institutional investors, pension and investment funds) have enlarged their market share. Disintermediation will be enhanced by the need for pension systems to rely more on funded retirement schemes.

Since capital markets are more integrated than the banking sector, disintermediation will foster the integration of the entire financial system in Europe.

Changes for the banking sector are in prospect once the new Basle Accord is applied. In general, we welcome the new accord if it helps to improve the allocation of capital. However, two special features of the German economy should be considered:

1. The German economy is largely dominated by small and medium-sized enterprises, known as the „Mittelstand“.
2. Our financial systems rely to a large extent on long-term financing.

This long-termism of financing has contributed successfully to the stability and prosperity of our economy, as well as the financial system. That is why the Bundesbank argues that banking regulation should not discriminate against long-term financial relations.

Small and medium-sized enterprises with a revenue of up to ϕ 5 million make up more than 95 percent of all enterprises in Germany. This „Mittelstand“ forms the backbone of the German economy. However, their share of outside capital is significantly higher than with larger firms. A lower rating is therefore to be expected, unless other collateral or risk-lowering factors are taken into account. Here again, we favour a differentiated approach that does not put banks with a large exposure to medium and small sized enterprises at a disadvantage.

IX

Banking regulation and supervision in Europe have become ever-more integrated, in keeping with the development of the single market. The introduction of the common currency in 1999 was therefore an additional factor contributing to the further harmonization of the regulatory and supervisory framework, accelerating the integration of financial systems.

Currently, we have a system of home-country supervision and extensive cooperation among European regulators and supervisors. This tried and tested framework is serving us well. Especially in the banking sector, integration is not yet so advanced as to justify pan-European supervision. Furthermore, tax systems, accounting standards and also banking systems vary to a degree that does not warrant unified banking supervision. As financial integration advances further, however, this situation may change in the future.

If, in future, once we have a truly European financial system, we will take steps towards a single supervisory structure. Those steps could probably start with the large, internationally operating, European banks.

In Germany, the government has recently drafted a bill on a new framework for financial supervision. The future "Federal Authority for Financial Services Supervision" will combine, under one roof, the supervision of banks, insurance companies and other financial institutions.

The Bundesbank’s role in the supervision of banks will be enhanced under the new law. This is a good thing, because there are good practical reasons for the participation of central banks:

- Central banks, by providing cash and liquidity, by running payment systems, and by operating in the open market, have a good insight in banking behavior and solvency. Therefore, economies of scope arise by providing both, central banking and banking supervision.
- Central banks have a responsibility for financial system stability, which is a prerequisite for the conduct of monetary policy.
- Central banks operate payment systems that are a potential source of systemic risks.
- And, at times of crisis, central banks have a role as mediators, as well as a potential "lender-of-last-resort" function. If liquidity assistance has to be provided for illiquid, but solvent, banks, national central banks would benefit from having "first-hand information", as supervisors, for the sake of maintaining or restoring financial stability.

Hence, once a European framework is envisaged for financial regulation and supervision, it must necessarily provide for the meaningful involvement of the ESCB. There is, however, no single solution to fit all countries and all environments. In Japan, as I have learnt, you have adopted a different approach.

X

Let us share a few thoughts on the international role of the euro.

Three years into its life, the euro is the second most important currency in the world. It took over that role from the Deutschmark.

The euro has a share of roughly 13 percent in international currency reserves – about as much as the Deutschmark had before. In this field, the dollar is the unchallenged leader, at two-thirds of international reserves. The size, depth and liquidity of the dollar markets, as well as the widespread habit of using the dollar for interventions and for pricing commodities, explain its predominance.

As regards its use as a store of value, we find some evidence of the growing importance of the euro. 30 percent of all international securities outstanding are denominated in euro. This share is slightly above the aggregate share of the predecessor currencies shortly before EMU was launched. That leaves the euro as the second-most-important currency in the international securities markets. Again, the dollar is the dominant currency, accounting for one-half of all international securities outstanding.

The currency composition of international bank assets presents a similar picture. Again, the dollar is the leading currency, with a share of 40 percent, while the euro is in the process of catching up. From slightly less than one-quarter at the end of 1998, its share rose to 27 percent.

What can we see from these figures? Although habits in the international use of currencies change only gradually, the euro has already won a respectable market share. Its market share roughly equals the economic weight of the euro area.

Further progress in the development of broad, deep and liquid financial markets is a precondition for the expansion of the euro's international role. Increased international use of the euro, as a currency for international reserve holdings, for investment and financing purposes, might have some bearing on monetary policy, but this potential impact seems manageable. Hence, in the Eurosystem, we have adopted a neutral stance towards the internationalisation of the euro. We regard it as a market-driven process, and we neither hinder it nor foster it.

XI

The euro currently plays a role in the exchange-rate regimes of 55 countries. Among these euro-minded countries are eight of the twelve countries willing to become member states of the European Union.

The motivation for aiming at joining the European Union is the prospect of stability and prosperity in a unified Europe. Soon after the Iron Curtain was lifted in 1989, the former communist states, with their centrally-planned economies, had negotiated "Europe Agreements" with the European Union. Those partnerships were meant to foster the transition process towards, first, democracies, and, second, fully-fledged market economies. Since then, a lot has been attained in terms of macroeconomic stability and prosperity.

Two weeks ago, the European Commission issued its annual progress report on the accession process. That report confirms the prospect of ten countries joining the EU as early as 2004:

- the three Baltic nations: Estonia, Latvia and Lithuania;
- five central and eastern European countries: Poland, Hungary, the Czech Republic, the Slovak Republic and Slovenia;
- and the two Mediterranean islands of Cyprus and Malta.

The process of accession is organized in three stages. We are currently in the pre-accession stage. The next step will be that of accession to the EU, and the final stage might be full participation in European Monetary Union.

Accession to the European Union is conditional on the fulfillment of the so-called "Copenhagen criteria". These comprise,

> First, "the stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for, and the protection of, minorities". This political criterion is already met by all negotiating countries.

> Second, “the existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the EU”. All of the countries envisaging accession in 2004 are functioning market economies. The EU Commission, in its recent report, also expects them to be able to cope with competitive pressures and market forces within the EU in the near term.
>
> And, third, "the ability to accept the obligations of membership, including adherence to the aims of political unification, as well as Economic and Monetary Union". The EU Commission recognizes substantial progress, in candidate countries, towards the adoption, implementation and enforcement of the "acquis communautaire" – the Community’s legislation.

The Copenhagen criteria define the common ground for the future EU.

Accession to European Monetary Union is conditional on "a high degree of sustainable convergence" (Art. 121 of the Treaty), as specified in the Maastricht criteria. They stipulate nominal convergence in terms of inflation rates, sound public finances, long-term interest rates and exchange-rate stability. Candidate countries can join EMU two years after their EU accession, at the earliest, as they have to spend at least two years in the European Exchange-Rate Mechanism ERM II.

There are still considerable discrepancies between the candidate countries and the present EU member states in their macroeconomic and structural data. Accession of the twelve candidate countries will increase the EU population by roughly one-third. Nominal GDP, however, will rise by only five percent.

The discrepancies today are more pronounced than they were in the previous three rounds of enlargement. The wealth gap between the current member states and the accession candidates is large. Per capita GDP (measured in terms of purchasing-power parity) is only 44 percent of the EU average. Furthermore, there is a striking degree of heterogeneity among the candidate countries themselves. Per capita GDP measured against the EU average ranges from 24 percent (Bulgaria) to 83 percent (Cyprus).

For convergence to be sustainable, it must be based on advanced economic and financial integration. The integration of the candidate countries with the EU runs deep. The EU is by far the most important trading partner of the accession candidates. Around two-thirds of their exports are destined for the 15 EU member states. In addition, two-thirds of capital inflows in the accession candidates during the nineties originated from the European Union. Real and structural convergence increase with ongoing economic and financial integration.

Ladies and gentlemen, EU enlargement is in fact a challenge. A lot of political work is yet to be done. Not only by the candidate countries, but also by the current EU, which has to reshape its institutions to be able to cope with the enlarged membership – probably 25 states in only two years time.

XII

Ladies and Gentlemen,

A stable and strong euro will serve as a catalyst of the ongoing process of European integration – among the present member states and the accession candidates alike. Euro banknotes and coins – to be put into circulation in less than five weeks – will soon become the most obvious symbol of a unified Europe. Political integration should receive a boost then, too.

“The euro changes Europe and the world”. Yes, so it does. And it is a change for the better. A Europe united by a common currency implies that the world's second-largest economic entity is a stronghold of stability. I am sure that a stable currency will strengthen the foundations of an orderly world economy and of productive global competition. And, I am sure, that Japan as a major player in the world economy will benefit as well.