Mr Stark discusses how the euro will change the world of finance

Opening Speech by Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, to the FERMA's Risk Management Forum, held in Berlin on 25 October 1999.

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I.

Ladies and gentlemen,

It gives me great pleasure to address this Forum of European risk managers here in Berlin today. With the introduction of the euro at the beginning of this year European financial markets have entered into a new era of rapid and profound change. The single currency will affect every segment of the financial services industry in the euro area in one way or another, although this impact and the pace of change will be different in various market sectors.

The most rapid change has already taken place in the euro money market, which, within a matter of weeks after the launch of the single currency, developed into a wholly integrated transnational market, providing the very basis for the money market operations of the European System of Central Banks, the Eurosystem. This was made possible by TARGET, a system which allows large-volume payments on a real-time basis throughout the euro area and which, after a few technical difficulties at the start, is in full and smooth operation now. Transnational payments within TARGET reached a daily average of 350 billion euro in July this year. TARGET thus ensures that cross-border arbitrage will eliminate short-term interest rate differentials. As a result, the EONIA rate and national overnight rates have entirely converged. Money markets have also adopted EURIBOR as the single short-term benchmark in euro, to which the short-term futures market and the long term swap market are linked.

Transnational integration is a much more gradual process in capital markets. Nevertheless, this process has already, within the first months of the new currency, acquired considerable momentum. In fact, the development of broad, deep and liquid capital markets covering the whole of the euro area is one of the great potentials of European Monetary Union.

It is the elimination of exchange rate risk that is driving this process of market integration, the major feature of which has been a far-reaching convergence of long-term interest rates. This process started well before the launch of the euro, when markets gradually began to anticipate that EMU would become a reality. As a result, interest rate differentials between 10-year government bonds of euro member states have narrowed to a range that, usually, does not exceed 40 basis points these days. This is a dramatic development if we recall that only at the beginning of 1996 this yield spread amounted to as much as 500 basis points in the case of some countries that are taking part in the Eurosystem today.

In the absence of exchange rate risk, spreads nowadays only reflect perceived differences in credit risk and liquidity. Increasingly, it is the latter prevailing over the former. I want to illustrate this point with an example: it would be very hard – if not absurd – to argue that it is a higher credit risk which is forcing the Netherlands to regularly pay about 15 basis points more on its long-term government debt than Germany. Clearly, it is the lower liquidity of the market for Dutch government bonds which is causing this spread.

It has been suggested recently that national governments in the euro area should pool their debt issuing in one central agency, acting on behalf of borrowing governments. This suggestion was made with reference to the greater liquidity that such a procedure would create for the euro-denominated government bond market and the savings in borrowing costs it would allow.

You will be hardly surprised that I do not agree with this proposal. Admittedly, there may be a few basis points that could be saved in the debt management of some governments of small countries and/or countries with low debt levels over the short run. However, by pooling debt issuing one would also pool risks and liabilities of the debtors. This would be a violation of Article 103 of the European

Union Treaty (ex-article 104b of the Maastricht Treaty), the so-called “no-bail-out clause”, which prevents governments from assuming any liability for other governments’ debt. Such sharing of liabilities, in my view, could create moral hazard that would undermine the credibility of the new currency. The result would be higher rather than lower long-term interest rates, leading to higher borrowing costs for member states.

The upshot of this is that for the time being we will not be able to create a euro-denominated government debt market of the same liquidity and homogeneity as the market for Treasury bonds in the US, unless we were to get a fully fledged political union with a supranational European government issuing substantial amounts of debt. I cannot see that happening in any foreseeable time span, although it could be the long-term result of a sustained evolutionary process of political integration.

II.

Let me return from the future to the present. We have seen that the euro is providing major impulses for capital market integration within the currency area. Given the greater market size, there has for instance been a strong trend towards bringing larger issues to the market. For example, issues of a size of 1 billion euro or more have more than doubled between the first quarter of 1998 and the first quarter of 1999 in terms of overall volumes.

Especially the market for corporate bonds is growing dynamically, albeit from rather low levels (due to the traditional dominance of bank credit in corporate finance in most countries of the euro area). In terms of overall volumes, the corporate bond market more than doubled between the first half of 1998 and the first half of this year. Overall private-sector issuing was 124% higher in the second quarter of this year than it had been in the same period a year before. Here too, the trend is towards bigger issues. Of the overall volume of corporate bonds issued 50% accounted for issues of a size of 1 billion euro or more.

There are mutually reinforcing factors at play here. Part of the recent dynamics in euro-denominated corporate bond markets has been driven by merger and acquisition activity that has greatly increased due to the restructuring needs of the corporate sector in the internal market of the European Union. Increases in the overall size of the euro-denominated capital market and in the size of individual issues have in many cases facilitated M&A activity.

The euro is also becoming an important international bond currency. In the first half of 1999 a net volume in bonds and notes of 75.5 billion euro was issued by non-residents of the euro area. This is an increase of almost 50% over the volume of international issues in the first half of 1998 (in the legacy currencies of the euro). In the same period net issues of Eurodollar bonds and notes decreased from 109 to 69.8 billion euro.

The integrative forces of the euro are also affecting equity markets in the euro area. By forming alliances, stock exchanges are facilitating access of their members to one another’s markets, thus simplifying cross-border trading. Such an alliance was formed in 1998 between the London Stock Exchange and Deutsche Börse AG. In May this year this bilateral alliance was extended to exchanges in Paris, Amsterdam, Brussels, Madrid, Milan and Zurich. In parallel (and in competition) to this alliance of exchanges, a consortium of major international investment banks has recently announced it intends to take over the UK-based electronic share-trading system Tradepoint.

Whatever the outcome of these alliances and ventures on the infrastructure of equity markets will be, equity portfolios of private and institutional investors in EMU member countries will diversify internationally, due to the elimination of exchange rate risk. This trend can already be seen among German mutual funds that invest in equities. Those funds focusing on German equities suffered a reduction in their overall amount of funds under management of 1 billion euro in the first half of 1999, whereas funds investing in shares representing the whole of the euro area raised additional capital of 2.4 billion euro in the same period. This trend is quite likely to continue and, possibly, accelerate.

III.

The euro will also act as a catalyst on the banking sector of the new currency area. Increases in capital market activities facilitated by greater market size are likely to foster securitisation and disintermediation. Classical bank lending is likely to suffer from this trend, which has already run its full course in the Anglo-Saxon countries. This kind of structural change in the banking industry will have winners and losers. This will certainly be so among corporate bank customers in Germany. As a general rule, small companies will find it harder to get access to bank credit than in the past, whereas larger companies may see their credit conditions improved including the possibility of direct access to capital markets. Whether such a system, on balance, is superior to the traditional relationship banking, which is still dominant in Germany, is hard to say.

One of the problematic aspects of the capital market system versus traditional bank lending could be studied in the US a year ago, when spreads for many medium-sized American companies (in the wake of the LTCM crisis) widened to such an extent that these companies were virtually cut off from external finance for several months. In systems with a strong and diversified basis of classical bank lending, "Mittelstand" companies, in general, will at all times find access to bank credit. To be sure, I do not believe that bank lending will be seriously threatened as a consequence of structural change driven by global trends and facilitated by the common currency. However, I feel that we need to watch this process of change carefully with a view to making sure that a banking structure that is ready to provide long-term finance to the many small and medium-sized companies remains intact.

The enlargement of financial markets due to the bigger currency area is likely to increase concentration in the banking industry. At the moment mergers are taking place mainly at the national level. The reason is that, especially, retail banking is still rather segmented due to legal and cultural differences in member countries. Cross-border mergers in retail banking look much less likely at present than in wholesale banking. However, new forms of retail banking, such as direct banking and discount broking, favoured by technological change, are winning market share. These new activities may be a playing field which lends itself more readily to cross-border activities than the classic branch retail banking.

Wholesale banking activities are likely to become increasingly concentrated in a few major financial centres of the European Union, with a small number of big investment banks that can take advantage of the economies of scale inherent in this business. At the same time smaller investment banks will, probably, retain strong positions in market niches. This process of restructuring and concentration will be accompanied by enhanced competition. As a consequence, the efficiency of the whole financial industry in Europe is likely to increase. Anti-trust authorities at the national and the European level, as I am sure, will carefully monitor this process to make sure that the intensity of competition does not diminish over the long run. In any case, the euro will considerably change the landscape of banking in Europe. There will be some degree of polarisation between a few big players in global investment banking and a bigger number of smaller credit institutions active in retail banking.

IV.

These internal changes in the financial services industry in Europe will also enhance the external significance of the euro. In general, the international role of a currency depends on three factors: firstly, the size and the openness of the currency area which it represents, secondly, the breadth and depth of financial markets in that currency and, last but not least, its stability record and stability prospects. It is obvious that the euro has a vast potential both as an international portfolio currency and as a major reserve currency. It is the task of economic policymakers in Europe to ensure that the economic benefits arising from the international role of the euro can be realised in full.

The benefits that accrue from the status of an international reserve currency have been demonstrated for decades by the United States. The US has not only received a steady stream of revenues from seignorage. They have also greatly benefited from the ability to finance large current account deficits over an extended period.

All this is due to the dominant international position of the (US) dollar. If the euro is to gain an enhanced significance in this area – and I repeat it has every potential to do so – it will be largely at the cost of the (US) dollar. Of course, the dollar will remain the most important international reserve currency for any foreseeable time. But the euro has the opportunity of winning a greater share in the reserve portfolios of central banks around the world.

V.

During the first half of 1999 the euro depreciated steadily against the dollar. The decline in the bilateral exchange rate accounted for about 10.8% between January and July 1999 (based on monthly averages). In the meantime the euro has, partly, recovered from these previous losses. The public debate about this depreciation, in my view, was sometimes ill-informed and mostly superficial. A central bank must primarily pursue internal price-stability. That doesn't mean that it should be indifferent to large fluctuations in the *external* value of its currency.

However, in the case of the euro it is essential to declare an unambiguous commitment to a strong currency policy, be it internally or externally. In this respect there was no lack of clarity on the part of the ECB. However, some European governments did, at least temporarily, create the impression that they had a preference for a low external value of the euro, believing this would stimulate economic activity at a moment when growth looked feeble and vulnerable with respect to the international financial crises around the end of last year. In the meantime, most European governments have become more sensitive in their public statements with respect to the external value of the euro. Awareness has grown, as one finance minister recently put it, that "we are all sitting in one boat".

A lot has been said and written about the underlying factors that may have caused the euro's initial depreciation, which should not be over-dramatised. Often cited were the cyclical divergences between the European and the US economies, with a continuing boom over there and a temporary weakening of activity here. Sometimes, part of the weakening of the euro was attributed to the crisis in Kosovo.

Although cyclical and political factors are important, the external value of the euro should, in a long-term perspective, be viewed as a general judgement of the markets on the attractiveness of investment in the euro area. Thus, markets assess very carefully, on a continuous basis, the internal economic and fiscal policies of the member countries of the euro, especially of the big economies. A failure to implement the necessary structural reform, especially in labour markets, and/or a backsliding on fiscal consolidation would present a serious risk for the prospects of the new currency, especially in foreign exchange markets.

VI.

On the other hand, the hope is justified that the euro will function as a catalyst for fiscal consolidation and structural reform. The euro could create peer pressure for best practice in economic policies among European governments. In this perspective, the increase in competition in markets, which I described earlier in the case of financial markets, would be reflected by an increase of competition between governments. If this catalytic role of the euro would become a reality – and to some extent it does already – this would also enhance the international stature of the euro.

In this scenario the euro would be likely to serve as a model for other regions. We are already beginning to see signs in other European countries of what might be termed "euroisation", albeit not yet on the same scale as what is involved in the issue of "dollarisation" that was recently raised in Argentina. However, following the introduction of euro notes and coins in 2002, the euro can be expected to be widely used as a parallel currency, most prominently in the transformation economies of Central and Eastern Europe. Many of these countries may choose to link their own currencies in one way or the other to the euro or are already doing so. This will enhance the role of the euro as an international transaction and invoicing currency in addition to the strengthening of its role as a reserve currency.

VII.

Let me conclude on the observation that the introduction of the euro will have profound effects on the world of finance, be it inside or outside the new currency area. In order to exploit the huge economic benefits of monetary union in terms of greater transparency, competition and efficiency, economic policies need to be soundly based.

As far as monetary policy is concerned, it is working on excellent institutional conditions: firstly, an independent central bank, secondly, a convincing monetary strategy (which faces transitional difficulties by working in an environment of rapid change in financial markets brought about by the euro itself) and, thirdly, a comprehensive range of monetary policy instruments.

Monetary policy, however, in order to be successful in the long run, needs the support of the other sectors of economic policy-making, namely fiscal policy, structural policy and wage policy. These policies remain largely within the responsibility of national governments and national wage bargainers. One of the crucial issues of the future will be the relationship between these national policies and the independent monetary policy of the supranational European Central Bank. Will the ECB be supported by continuing fiscal consolidation and structural reform or will there be conflict between monetary policy and the other economic policies, resulting in an uneven policy-mix? There is a lot at stake. It is crucial that the sense of responsibility of national governments and wage bargainers will grow and reflect the new reality, the new policy regime, we are in now.