Willem Duisenberg: E-economy: will we still need banks in the future?

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the Seventeenth German Banking Congress held in Berlin, 4 April 2001.

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Ladies and Gentlemen,

I am very pleased to have the opportunity to speak here at the Deutscher Bankentag in Berlin today. It is a great pleasure to address so many bank leaders operating in the German - and of course, by implication the European - economy.

One of the most striking economic events of the last years has been the pace and depth of change in information and telecommunication technologies, of which the development of electronic money is a good example. Some claim that these developments in information and telecommunication technologies have triggered a New Economy. In my remarks today, I would like to first discuss the economic opportunities being created by the potential emergence of this New Economy in the euro area. In a second part, I will more specifically review the development of electronic finance.

There is no undisputed and unequivocal definition of what should be understood by the term "New Economy". As a central banker, I would like to trace a sharp distinction between a more popular notion of the New Economy and a more fundamental vision. The more popular notion of the New Economy that could be mainly found in the press covers a wide spectrum of statements. For example, it was sometimes claimed that stock market prices had reached a permanently higher plateau and that further exceptional rises were to come. Others claimed the death of the business cycle or, in a more realistic version, that business cycle fluctuations could now be expected to be significantly and permanently dampened by the emergence of a New Economy. We cannot fully judge this at the current stage. And uncertainties regarding global economic developments have more or less pushed the discussion about the New Economy into the background.

Therefore, in my comments, I shall adopt a rather cautious approach and address the more fundamental issues related to the New Economy. In my interpretation of the debate, there are two main components in the concept of the New Economy. These relate, first, to the way in which the New Economy manifests itself and, second, to the conjunctions of particular events that accompany the emergence of the New Economy. First, the New Economy is seen as leading to a permanently higher rate of potential output growth, with productivity gains driven by technological innovation being the main motor behind the upsurge. The increase in productivity growth that has been regarded as characterising the New Economy is typically seen as the result of an underlying economic process which may take some time to bear fruit and therefore may clearly precede the emergence of the symptoms of the New Economy in macroeconomic data. Increased investment in computers, software, peripheral equipment, network infrastructure and other information and communication technologies are generally regarded as the most salient driving force behind what has been perceived as a new pattern of growth.

Second, the New Economy is seen as being closely associated with the processes of deregulation, particularly in labour markets and network industries such as telecommunications, and globalisation, particularly in financial markets.

Other accompanying conditions, such as increased competition and flexibility in domestic goods and factor markets, as well as a stable macroeconomic environment, are also indispensable components of the same picture, if not equally powerful determinants of the phenomenon. They allow the full potential of technological innovation to be exploited and ensure that a faster pace of economic expansion and employment can be achieved on a more sustained basis and without destabilising inflationary pressures.

The ECB cannot, however, "create" a New Economy through its monetary policy. The New Economy depends mainly on technological progress and the liberalisation of markets. However, the ECB can provide a positive contribution to growth and employment prospects by safeguarding price stability. Maintaining price stability is the ECB's primary objective. Unfortunately, this is sometimes forgotten. In the long run, pursuing this objective will help the economy to enhance its growth potential. In this context, the Governing Council of the ECB, at its meeting last Thursday, confirmed the "wait and see" position with regard to the monetary policy stance. In an environment of increased uncertainty about the global economy and its impact on the euro area, the Governing Council is carefully assessing whether and to what extent upward risks to price stability will continue to decline. As far as the first pillar of our monetary policy strategy is concerned, the decrease of money growth indicates that upward risks to price stability have receded. As for the second pillar, domestic upward price pressures may decrease as a result of somewhat lower than expected GDP growth in the euro area. However, due to the risk of secound-round effects from past oil price increases, wage developments will be monitored carefully, as these might result in upward price pressures.

In the financial sphere, the advances in information and telecommunication technologies have started to have their effects. This was perhaps even more visible than in the non-financial sphere.

In the **banking sector**, a development that has attracted considerable attention over recent years is the emergence of internet banking. The first financial products and services to be distributed over the Internet were rather standardised ones, in fields such as securities brokerage and payment services. More recently, a wider array of financial products and services have become available over the internet, which has thus become an important distribution channel for a number of banks. Many banks in the euro area have already developed the internet channel to various degrees. There even exist some banks with few or no physical branches, which rely on the internet and the telephone as their main channels of communication with clients.

In general, the development of internet banking appears likely to reduce the franchise value of banks as it contributes to an intensification of competition in the banking sector. Certain commentators even consider that competitive pressure may lead to the separation of various banking activities traditionally performed under the same roof. In the view of these commentators, activities such as deposit taking, payment services and lending could be split up because Internet banking would diminish the traditional synergies between them.

What I would like to bear in mind from the discussion on this issue is that, with new information and communication technologies, business practices in the banking industry can be expected to evolve considerably in the near future. For example, advances in data processing as well as in business models may make it possible for banks to make more efficient use of information on customers' business habits, and apply e.g. new credit scoring and other methods of analysis.

Customers are likely to benefit from these developments in several ways. Thanks to intensified competition, they are likely to get better and more efficient financial products and services. In particular, new technology such as home banking should contribute to reducing the time and effort spent by customers in purchasing financial products and services. Under the influence of changes in banking practices, customers may be able to have access to a wider range of financial products and services. Furthermore, efficiency gains will allow products to be offered at lower prices. In the euro area, electronic finance thus compounds the effects of the creation of the single currency, adding impetus to progress towards integrated financial markets at an area-wide level.

Monetary policy needs to take account of these developments. In particular, it is important to monitor the resulting modifications to the financial structure of the economy so as to be able to track changes in investor behaviour, not least in order to assess the transmission channels of monetary policy.

Moreover, in this context the possibility of excessive risk taking in the banking sector should not be neglected. Faced with eroding margins in "old businesses", banks may develop their activities in heretofore unexplored fields, by geographical expansion or by product development. In such circumstances, some banks may misjudge the risks inherent in the new activities, as a result of a lack of information, knowledge or skill. In such a situation, the prudential supervision of banks can help by assessing whether the capital buffers of banks remain sufficient for the banking sector as a whole.

In **financial markets**, the issues are broadly similar. It is widely recognised that financial markets have been significantly transformed by the emergence of on-line brokers and electronic trading systems over recent years. In general, these developments have the potential to improve the functioning of financial markets.

For example, on-line brokers often provide clients with detailed information regarding market conditions and the execution of orders. Greater transparency on the part of brokers reduces the information asymmetry between brokers and customers. As a result, customers may be able to obtain better execution prices, not least because they can more easily see the prices quoted by various brokers.

Although the electronification of financial markets can bring benefits to customers, some risks are also associated with it. The first type of risk is by nature operational. Advances in information and telecommunications technologies have made it easier than ever before to set up exchanges for financial products, for example on the internet. In the early stages of their development, the new trading systems need to be thoroughly tested so as to ensure maximum security. In particular, it is important for them to be able to withstand turbulent market conditions, including periods of exceptionally high trading activity and market volatility. The second kind of risk arises from the possibility of a disorderly segmentation of financial markets. As new trading systems are developed, the possibility exists that trading activity becomes spread over a number of exchanges. Competition between exchanges is generally beneficial. However, customers may, at least over a transitory period, be faced with some difficulties in accessing the new exchanges. Until the changeover is complete, customers may thus be unable to always obtain the best execution prices. In order to deal with this problem, it is important that the new exchanges establish clear rules regarding participation and price quotation as soon as possible in the process of starting their operations.

Finally, I would like to say a few words about **electronic money**. E-money is still very much in its infancy but has the potential to develop. In the euro area, various e-money schemes exist. Although the volume of e-money in circulation currently remains very low in the euro area, the number of devices already in circulation suggests that usage could expand rapidly ("*Issues arising from the emergence of electronic money*", November 2000 edition of the Monthly Bulletin of the ECB, p.49-60.)

In this context, it was important that the regulatory framework was clearly set up at an early stage so as to reduce uncertainty. In my view, this will encourage innovation. I am glad to say that the framework adopted in the European Union has the advantage of ensuring a high measure of security for customers, in particular through providing protection against counterfeiting and money laundering.

For monetary policy, there are three main issues arising from the emergence of electronic money. First, it is important that electronic money does not jeopardise the unit of account function of money. In other words, electronic euros stored on a payment card must have the same value irrespective of when and by whom the card was issued. This important principle has been safeguarded in European legislation through the imposition of a redeemability requirement for e-money.

Second, monetary policy must remain able to steer money market interest rates. I believe that this will continue to be the case as long as money market participants need to have recourse to the central bank for providing the final means of settlement.

Third, electronic money, as a close substitute for banknotes and coins, needs to be included in the definition of monetary aggregates. Therefore, even though e-money currently remains in its infancy, the ECB has started to collect data on the amounts of electronic money in circulation.

Without going into further details on these issues, let me emphasise that we are confident that electronic money will not pose risks to the ECB in the pursuit of its objectives.

To conclude my remarks today, I would just recall that, in particular in the financial sphere, remarkable changes have taken place already. Banks have developed new products and services as well as new ways to commercialise them. Financial markets have been transformed by the emergence of electronic trading systems.

These developments can be a source of great benefits since they generally tend to augment the range of options available to borrowers and investors. This may contribute to a better allocation of financial resources in the economy and, thereby, eventually to higher economic growth. As in all periods of rapid change, there are some risks associated with the developments currently underway. However, I am confident that these risks can be addressed satisfactorily, allowing the euro area to reap the benefits of e-finance.