Ernst Welteke: Germany as a financial centre – European perspectives for Japanese markets

Lecture by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Finanzplatz-Dinner, Tokyo, 29 November 2001.

*   *   *

I

Ladies and Gentlemen,

First of all, I would like to thank you most sincerely for this opportunity 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 chances and prospects for Germany as a financial centre.

Looking at the financial centre Germany (which we call "*Finanzplatz Deutschland")*, we have to take a European perspective. Germany and eleven other European states have formed the European Monetary Union with the European Central Bank located in Frankfurt. This union is only one month 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 single 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 minor-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

Clearly, the enlarged currency area and the integration process are of utmost importance for growth and stability of the German economy and for the expansion of the financial market in Germany.

Therefore, let me start with a few figures about the euro area. Its size of population, with roughly 300 million people, is 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 per cent of our GDP of six-and-a-half billion euro is generated by exports, and the current account is roughly in balance. The euro area generates almost one-fifth of world exports.

Average per capita GDP stands at somewhat more than € 20,000 (roughly Y 2.2 million), a third less than in Japan. Differences between individual countries are considerable.

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

Germany has 82 million inhabitants or about 28 per cent of the euro area's combined population. Germany's share in domestic product is about a third of the euro area. In terms of foreign direct investment and trade, the German economy is even more intertwined with the world economy than the euro area. About a third of our national income is generated by exports.

This share may even rise after the integration of the central and eastern European states. Within the foreseeable future, some of our neighbouring countries will join the European Union and maybe also the Monetary Union. Germany, at the moment still a border territory of the euro area, will become the geographical centre of the union. Since these countries are in the midst of a catching-up process, we will clearly benefit from their dynamic economies.

III

I am well aware that the most important effect that the currency union will have on markets is by its performance – mainly through the degree of price stability achieved.

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

This year, after peaking in May at 3.4 per cent, the inflation rate has been decreasing. In October, prices were 2.4 per cent 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 increases. 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 per cent.

A generally stable currency, and markets that trust the stability-orientation of the central bank, 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 in the USA. 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.

IV

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 per cent in international currency reserves – about as much as the Deutschmark had before. In this field, the dollar is the unchallenged leader, with 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. The need to diversify and the growing importance of European financial markets make a rising share of euro reserves in central banks‘ portfolios possible.

As regards its use as a store of value, we find some evidence of the growing importance of the euro. 30 per cent 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 per cent, 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 per cent.

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.

V

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.

Correspondingly, 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 is speeding up financial market integration.

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 $\text{RTGS}^{\text{plus}}$ (Real Time Gross Settlement), which improves security, reduces liquidity needs and expedites settlements of large-value gross payments. Through this system, about 8,500 banks and credit institutions, including their branches all over the world, are accessible.

VI

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 now. The remaining spread is mainly due to the varying liquidity of the paper 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. Country diversification is being substituted by industry diversification.

The volume of German government bonds is second in Europe only to the Italian bonds. Nevertheless, the ten-year German government bond, known as the "*Bund"*, enjoys benchmark status in EMU with the lowest yield and a remarkably liquid market.

The "*Bund"* is the main underlying product for the contracts of Eurex, the derivatives exchange in Frankfurt. Since three-quarters of all bond futures traded in Europe are euro-Bund futures, Eurex has become by far the leading derivatives exchange in the world. With almost 500 million contracts, Eurex has clearly outperformed all other derivatives exchanges. Eurex is a good example of the international attractiveness of the German capital markets. More than 60 per cent of the participants in Eurex are non-Germans.

Looking at corporate bonds, we can recognise the emergence of a "high-yield" bond segment in Europe and especially in Germany. Corporates are becoming increasing popular among both issuers and investors. In this way, firms become independent of bank financing and investors esteem the higher yield and the opportunity to diversify. Much new issuance is generating a high growth rate in this segment. The volume of non-public bonds in Germany is only about a sixth of the corresponding figure in the USA, but it is more than twice as much as in any other European country.

A speciality of the German capital markets are the mortgage-backed bonds and municipal bonds known as "*Pfandbriefe*". Both are a kind of asset-backed-security. The German "*Pfandbrief*" became so popular that other European countries copied the idea. Investors can gain some additional yield over public bonds, but without much risk. About 38 per cent of the issuers are triple-A-rated. "*Pfandbriefe*" are now issued in larger volumes and are placed internationally.

There are three developments which increase the German bond markets' attractiveness for both issuers and investors:

- a higher turnover and therefore increased liquidity,

- many new issuances and therefore more opportunities to diversify, and
- a wider range of products, and therefore more chances to satisfy the needs of investors.

VII

As in the bond markets, 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 per cent. The matching figures for the USA and Japan are 152 per cent and 68 per cent, respectively.

However, equity markets in the euro area are growing fast. The ratio of new issuance to market capitalisation averages over 4 per cent. This is twice as much as has been achieved in the USA or Japan.

Germany has outperformed within the euro area in terms of the number of listed companies, of new stock issues, and of market capitalisation. The most impressive feature, however, is the ongoing growth of the capital markets and the potential to continue growing.

Market capitalisation as a ratio to GDP in Germany is about 60 per cent. This reflects our bank-dominated financial system. However, market capitalisation of domestic stocks grew over the last decade by 17 per cent per year.

The turnover growth of the German equity markets is also reflected in a rising importance of investment funds and their assets. In Germany some 6,800 funds manage assets of more than 800 billion euro. Over the last decade the number of funds almost tripled, while their assets rose by 18 per cent per year.

The German capital market has been able to provide the bulk of start-up financing in Europe. More than 200 venture capital companies operate in our country. They serve as a catalyst for new companies and – in the event of success – as a pacemaker for initial public offerings (IPOs), especially on the "*Neuer Markt*", which is the high-tech and innovative segment of the German stock exchange.

Germany benefits from a high degree of international attractiveness of its capital markets. About 235 foreign companies have their stocks listed in Germany, a number which is topped only by the USA and the UK. Germany is, of course, among the leading centres for central and east European business.

In comparison to equity markets of other leading industrial countries, the German equity market has a remarkable potential for growth. Of the 3 million companies in Germany, only one-fifth are organised as corporations. Some one per cent of these are stock corporations. A little more than a tenth of these are listed on the exchange.

Clearly, the stock corporations are more important in economic terms than their number suggests. But it is equally clear that even a small additional number of IPOs would cause a real surge in issuance on our capital markets. There are many initial public offerings in the pipeline. Quite a lot of medium-sized firms are thinking about using the financial opportunities offered by our liquid and well regulated equity markets. Two years ago, we witnessed the first municipal company to go public (Mannheim utilities) and there are hundreds of possible followers.

As a result, a shareholder culture is emerging very fast. Compared to the USA and the United Kingdom, the percentage of shareholders in the total population is low in Germany – just like in Japan. The percentage in the USA and UK is about a quarter of the population, while our countries show little less than ten per cent. However, to judge this number for Germany you need to look at the historical development. The number of people holding shares and mutual fund units has doubled since 1997 and is still increasing, even this year. This clearly proves that we have an emerging equity culture.

What is equally important is the changing structure of shareholdings in Germany. Investment funds, private households and foreign investors have a rising share, while the former dominance of companies as shareholders has vanished. The old picture of "Germany Incorporated" is disappearing and a market-based culture is emerging. This process will accelerate even more because capital gains from the sale of corporate shareholdings will be tax-free as of 2002.

The overall picture of the German equity market is that of a high quality market, less important than those in the anglo-saxon world but with a high growth potential. The realized growth rate in the recent years is indeed impressive. For investors this provides a good opportunity to join the markets. A potentially high growth rate means better chances for gaining market share than a saturated market.

One important medium and long-term effect is coming from the changes in the statutory pension schemes. Japan, Italy, and Germany are the countries with the most rapidly ageing population. In 2040 – according to demographic estimates – every working person in Germany will have to support one pensioner. And up to now our pension systems have mainly been financed on a pay-as-you-go basis. Probably less than 20 per cent of pensions are paid out of funded pension schemes. This share will rise because of the recent reform of the pension system and because of the rising number of pension funds. That also justifies the expectation of an ongoing growth rate for turnover and stocks on the German capital markets.

One major asset for our capital markets are the highly efficient exchange structures, including the high-technology systems. But that applies only to the national markets. Looking at Europe or the euro area as a whole, we must admit that there is a segmentation of both stock exchanges and clearing and settlement systems. Even in Germany, besides the dominant Frankfurt Stock Exchange, there are seven regional stock exchanges which focus on special services and the specialisation or particular strength of their regional economy.

This segmentation is hampering financial market integration to a considerable extent. A consolidation process has started and should be boosted further by legal harmonisation in the field of financial services. This weakness will be overcome step by step: The European Commission’s Financial Services Action Plan provides 42 proposals to frame legislation aimed at establishing a uniform European capital market by 2004.

VIII

Let me share some insights with you into the European and German banking sector. The degree of European 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 totalled about 108 per cent 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 per cent of GDP, and for 110 per cent in Japan, while the US figure is only about 40 per cent.

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.

Another trend is the centralisation and consolidation within the banking sector. The financial centres, and among them especially Frankfurt, will benefit from that trend.

IX

One could argue that financial services will be provided at the location of demand and that a centralisation does not necessarily improve efficiency. However, economies of scale, economies of scope, and the motivating and innovation-stimulating effect of personal (face-to-face) contact add up to large benefits for financial centres.

Globalisation in world financial markets therefore means concentration. There is only room for a few large financial centres in the world, probably one or two for each time zone and some niches for minor players and actors.

There are a couple of hard facts which prove the qualifications of Germany (Frankfurt) as the leading financial centre in the euro area:

- a stable currency,
- a full range and multiplicity of financial institutions, instruments and products,
- a high volume of funds available for investment,
- an innovative financial culture,
- an efficient legal framework,
- a sound and competitive banking system, and
- a strong national economy in the background.

The German financial centre is not restricted to Frankfurt. Important locations for financial services are for example Düsseldorf, Stuttgart, Berlin and Munich.

Munich is the third largest location of insurance companies worldwide and leads the world in terms of insurance premia. There are 280 insurance companies located in that city, of which 80 maintain their head office in Munich. Among them is the largest reinsurer in the world.

In addition, the internationality of Frankfurt and Munich is an important aspect. Frankfurt hosts the head offices of as many as 136 foreign banks, among them 13 Japanese banks. Frankfurt has a lively (English speaking) international financial community.

This has grown considerably since the ECB was located in downtown Frankfurt and all of those ECB watchers joined the former Buba watchers in our city. Frankfurt is the "City of the Euro". A couple of international trade fairs, international schools and universities and, last but not least, the large airport and traffic hub "Rhine-Main" provides the necessary international flair.

What we are working on now is the improvement of our intellectual infrastructure. This comprises the need for internationally comparable education degrees, the concentration on finance and banking as well as professional schools for further education. Much has been achieved in this field, but we have to improve to serve the recruitment needs of a financial centre.

X

Ladies and gentlemen,

The new currency is a symbol of European integration. That has attracted a lot of interest in currency unions and in Europe all over the world. We are both pleased and proud to see this heightened attention for this unique historic event and the ongoing integration process in Europe.

Today I wanted to draw your attention to the integration and development of financial markets in Europe, with a focus on Germany. I hope that I managed to give you a reliable and true picture of the financial markets in Germany.

But that is only part of the story. Listening, talking and hearing about it is not nearly as interesting and informative as going there and gaining insights yourself. You will always be welcome.

Ladies and gentlemen, thank you for your attention.