Mr. Schieber considers the impact of EMU on the banking structure in Europe

Speech delivered by Mr. Helmut Schieber, a member of the Directorate of the Deutsche Bundesbank, at the symposium organised jointly by the Greco-German Chamber of Industry and Commerce and the Bank of Greece, as part of the "Money Show" in Athens on 14-15/11/98.

I

Money and wealth, as the Stoics knew long ago, are not bad in themselves. They can be used for good or ill. When applied to stage three of European economic and monetary union, which begins in only seven weeks, this means that the quality of the euro will depend on decision-makers within the ESCB consistently gearing their monetary policy to achieving and maintaining stability. If the euro is to be a success, its future price stability will be of paramount importance. The new currency will be a success story in the international financial markets only if we can build up confidence in it.

The changeover to stage three of European economic and monetary union will have implications for everyone in business, in politics and, naturally in a very special way, in banking. EMU is creating a new set of conditions under which the credit institutions are to conduct their business and to which they must adjust. For example, the transition to a single monetary policy in Europe will bring about a direct change in the refinancing structures of credit institutions.

The single currency and the integration of the European capital markets represent an enormous challenge for the European banking sector. Firstly, the credit institutions not only have to absorb the additional cost burden of the conversion to the euro but must also sustain losses of revenue resulting from the disappearance of profitable lines of business and the simultaneous intensification of competition within the entire financial services industry. Secondly, monetary union provides competitive institutions with new opportunities for earning money by repositioning themselves operationally and regionally, in their products and in the sales channels.

I shall therefore start by examining how the new set of monetary policy instruments will change the refinancing structures and money market conditions in Europe before turning to the future international role of the euro and its impact on Europe's banking landscape. I shall conclude by setting out the criteria for the euro to succeed.

II

The General Documentation on ESCB monetary policy instruments and procedures, whose final version the ECB published only last month, form the basic foundations for the integration of the European money market.

When choosing its monetary policy instruments, the ESCB was guided by the principle that access to refinancing funds should be widely available and that institutions within the euro area should be treated equally. When devising the instruments, account was taken of the market principles laid down in the Maastricht Treaty.

Two standing facilities are available to business partners within the ESCB. The interest rates for the marginal lending facility and for the deposit facility mark the ceiling and the floor, respectively, for the day-to-day money market rate.

Open market operations, which are the crux of the regular interest rate and liquidity policy management of the money market, are carried out within this interest rate corridor. This means that the present monetary policy practice in most of the participating countries is being continued. The main weekly auction with a 14-day maturity forms the key element of regular money market management. It is used to provide liquidity to the banking system from week to week and to illustrate or revise the basic monetary policy stance of the ESCB. The longer-term refinancing operations represent what for Germany, too, is an innovation. Carried out at monthly intervals and with a maturity period of three months, it serves as the basic means of supplying the banking system with central bank money in order to help stabilise refinancing and the security of operations of the banks, especially the smaller ones.

However, the set of monetary policy instruments does not come into play only in the provision of central bank money. It is only the minimum reserve instrument - which is also deployed in Greece - that creates a sufficiently stable demand for central bank money on a permanent basis. At the same time, the minimum reserve has a stabilising effect on interest rate trends in the money market by providing the institutions with the possibility of cushioning the effects of temporary fluctuations in liquidity. The result is that the central bank has to intervene only to a comparatively small extent; the decentralised structure of the ESCB is underpinned. A major innovation - at all events, from Germany's point of view - is the market-related remuneration of minimum reserve balances. In this way the banks' refinancing costs incurred as a result of holding minimum reserves are fully offset. That is an important factor with respect to the acceptability and competitive neutrality of the minimum reserve system.

Not only the single monetary policy but also a uniform technical infrastructure is essential for the creation of a single money market in Europe. The effective implementation of monetary policy measures and the distribution of central bank money through the future European money market presupposes that there is a correspondingly competitive and efficient large-value payment system for the euro. TARGET has been conceived as a decentralised system which is based on the national real-time gross systems which are connected to each other through an Interlinking system. This enables the national systems to settle payments both nationally and internationally. This creates a satisfactory market depth for the European money market and strengthens the position of Euribor in relation to the British Euro-Libor in competing for recognition as the reference interest rate for European financial trading.

III

How the euro fares internationally as a transaction, investment and reserve currency will be of enormous importance for the future business opportunities of the credit institutions in the euro area. I think credit institutions in the member countries will have an excellent opportunity to expand their business operations if we are successful in making the euro one of the internationally used currencies which might assume a more important role in the global currency system than the currencies of the 11 countries initially participating in EMU taken together.

In the short term, however, the introduction of the single currency will mean a loss of profitable areas of business for the credit institutions. This applies first and foremost to foreign exchange trading. It is estimated that, as a result of EMU, there will be a 10 % to 15 % reduction in intra-European foreign exchange trading. This decline will be spread unevenly over the financial centres. On the European foreign exchanges outside London and Frankfurt the foreign exchange trading of the respective local currencies against the D-Mark accounts for up to 50 % of total trading in foreign currency. In the EU, foreign exchange dealing in non-European currencies amounts to no more than just under 30 % of the total. The banks will therefore lose a major area of business, especially as it is likely that future euro-dollar and euro-yen trading will be concentrated on a small number of dealers. They will have to focus their trading operations on other segments, such as trading in central and east European currencies.

Over the longer term, however, the single currency in Europe is likely to provide a positive stimulus to the credit institutions' business operations. With the disappearance of currency barriers the capital markets will gain in breadth and depth; prices will become more transparent and will tend to fall. Financial markets with a large range of products, a broad range of maturities, a high level of liquidity and low transaction costs will attract an enormous amount of international custom and will attract both international investors and borrowers.

Whether or not the euro will succeed in competing with the US dollar as a vehicle currency will be of paramount importance for the international use of the euro and therefore for the credit institutions' business opportunities in the euro area. Vehicle currencies always emerge when currencies can be exchanged indirectly via this vehicle currency more cheaply than would be the case if they were exchanged directly. The inertia that favours the US dollar as a vehicle and reserve currency, however, may represent a certain barrier to the development of the euro in this field. The concentration of transactions on a currency will be fostered by economies of scale. The greater the share of a currency in the world's monetary reserves, in private assets and in global turnover, the lower are the transaction costs associated with trading in it. Besides, a certain degree of inertia impedes a change of the existing vehicle and reserve currency. Although that doesn't mean that a change in a currency's functions is impossible, the elasticity of substitution between the US dollar and the euro is likely to be relatively small, at least initially, for the reasons mentioned.

Nevertheless, the euro's functions as a transaction and investment currency will give the credit institutions in Europe an excellent opportunity here to gain a foothold in the new business areas and thus to open up new sources of revenue for themselves.

IV

The strong and rapid structural change in the financial sectors of the past few years will continue with the introduction of the single currency in European monetary union. For the financial services suppliers, this will result in a significant intensification of competition; EMU will act as a catalyst and encourage other trends such as disintermediation, internationalisation, technological change and a transformation of customer behaviour. For the banking sector this development will generate unprecedented pressure for radical restructuring and consolidation.

EMU is hitting the European banks at a time when they are already suffering from a deterioration in their profitability. Considerable investment in information and communications technology in connection with EMU are now leading to additional costs while profitable business areas are being lost at the same time. This means initially that there will be further pressure on the already narrow margins of banks in continental Europe. This will inevitably force them to re-examine their commercial strategy, with the primary objective of lowering costs.

The effect of monetary union on the profitability of the banks will depend on each bank's specific business structure. Institutions which are already geared to operating internationally and tend to operate to a greater extent in wholesale banking will find that the introduction of the single currency in Europe exposes them to even stiffer competition than it does smaller banks, which operate mainly in retail banking. The latter will retain their local or regional significance or will define themselves as “niche suppliers” of specialised products.

The necessary reduction in overcapacity as a result of greater competition will be seen as the main challenge for the entire financial sector. However, the special role of the banking industry in the economy calls for a more varied assessment of this more intense competition. The main reason for this is the key position that the banking industry has in payments and in lending. It must also be remembered that credit institutions operate with a lower capital ratio than other types of enterprise and are therefore more prone to risk. This means that it is essential that the process of consolidation in banking occurs in an orderly fashion; in other words, without endangering the stability of the entire system.

Only a stable financial system provides a reliable base for the real economic development of an economy. Consequently, efforts to achieve a degree of concentration in the banking sector must not reach a stage where they encourage the development of a too-big-to-fail mentality, which might excessively heighten the banking industry's willingness to take risks. Another point is that the concentration of credit risks on a few large institutions tends to increase the danger of banking crises with undesirable implications for the economy as a whole.

The structure of the banking system is also very important for monetary policy. Credit institutions have an extremely important part to play in the monetary transmission process. The comprehensive range of business activities provided by the universal banks and the large number of credit institutions in Europe guarantee a broad "interface" for the transmission of monetary policy objectives. Competition among the banks also plays an important role for the effectiveness of monetary policy because changes in interest rates can be passed on as quickly as possible to the economic agents only if there is a sufficient level of competition. The transmission channel will be kept relatively short as a result, and monetary policy stimuli will have an early impact on the spending of the economic players. At the same time the banking system must be stable and sufficiently profitable to make it possible, where applicable, to sustain the consequences of strong monetary policy stimuli as well.

V

The market's confidence in the stability of the new currency is absolutely essential if the euro is to be used intensively internationally. The success of the euro will be measured in terms of future price stability, and the expectations of market participants regarding that success will be of paramount importance.

The starting conditions are favourable for ensuring a stable euro. The average inflation rate in the 11 countries participating in EMU has never been as low as it is now. The increase in prices was 1.0 % in September 1998 compared with the same period a year earlier; this compares with an annual average of 1.6 % in 1997 and 2.2 % in 1996. In this respect European monetary union can claim to have achieved a respectable and notable degree of success in convergence.

A crucial factor for the stability of the euro stems from the fact that the single currency and supranational monetary policy will continue to be accompanied by national fiscal, structural, wage and social policies.

The abolition of exchange rates and of national interest rate policies will reduce the scope for action of all of the participating states. In future, the only possibility of coping with differences in the economic cycle and different response patterns to asymmetrical developments in the EMU countries will be by means of the economic policy instruments which remain within the sphere of national responsibility.

Satisfactorily functioning markets for goods, services and labour, with flexible costs and prices will play a key role in overcoming future asymmetrical shocks in Europe. Responsive fiscal, social and structural policies will likewise grow in importance as instruments of economic policy adjustment. Recognition of this fact was also a motive for introducing the Stability and Growth Pact. Only those countries which are in a healthy condition economically and have a budget which is balanced or in surplus will be able to enjoy a certain leeway in a recession and pursue an expansionary fiscal policy without risking structural deficits.

How do things look in reality? Most countries are quite some way from achieving a balanced budget. Many countries reached the convergence mark of 3 % for the current deficit only after making considerable efforts. In some cases they did so only by resorting to one-off measures, the costs of which were simply shifted to future budgets. Particularly countries with a high level of debt were able to meet the deficit criterion only through all-time low market interest rates. What is more, these countries' large debt, which is frequently incurred at the short end of the market or at variable rates of interest, harbours a considerable measure of potential conflict for monetary policy makers. Any restrictive monetary policy measures by the ECB would have a direct impact on these countries' interest payments and place a burden on their current budgets.

Among the serious problem areas in Europe is unemployment, which persists at an intolerably high level. It is true that a few countries such as the Netherlands, or Denmark and the United Kingdom (which are not yet participating in monetary union), point to a possible way out of the crisis in Europe. However, the situation in the large countries of Germany and France indicates simultaneously the inability of the labour markets to react flexibly to the problem of permanently rising unemployment.

VI

During the past few weeks there has been a tendency in some quarters to try to exert a political influence on the consistent stability-oriented monetary policy in Europe. However, the priority given to the objective of stability and the independence of the ESCB as the essential elements of the Maastrict Treaty must not be called into question. Monetary stability is a precondition for - and not an alternative let alone an impediment to - achieving an appropriate measure of economic growth and for solving Europe's employment problem. No monetary policy can solve structural problems which have their origins in national trends in fiscal, economic, wage and social policies.