Mr Quaden addresses the impact of the single currency on the financial markets and looks at the international role of the euro

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium and a member of the Governing Council of the European Central Bank, at a conference by the Belgian Banker's Association (ABB) in Brussels on 14 October 1999.

* * *

I would like to leaf with you through the photo album of a baby, whose name is euro. He is now nine months old and he took years, not months, to conceive.

Introduction

On 1 January 1999, the final phase of Economic and Monetary Union (EMU) started with the successful launch of the euro. This followed a period of both intensive technical preparation and considerable progress in the economies of the participating countries. The changeover of all operations on 4 January went without upset and the major technical and logistical challenge which the preparation and success of the conversion weekend represented, has been fully met.

Since the beginning of this year the Eurosystem, made up of the European Central Bank (ECB) and the 11 participating central banks, is responsible for the conduct of a single monetary policy for the whole of the euro area. Assessing the first nine months of EMU means first to focus on how the new System has been put in place and how it has been able to conduct the new single monetary policy efficiently.

Monetary union also marks a significant milestone in the process of European integration, whose first beneficiaries are the financial markets. Their integration must indeed complement the integration of the goods, services and capital markets. I will successively address the impact of the single currency on the money markets, the bond markets and the equity markets.

To conclude I will turn to the international role of the euro. Does the euro succeed a few months after its birth in becoming a genuine international currency?

The single monetary policy

On the macroeconomic level, the birth of the euro has not only meant the coming of a new international currency, but also the emergence of a new supranational body, which has as its task to implement the new single monetary policy in an independent way and with the participation of the national central banks.

After a conversion weekend, during which the whole of the interbank payment systems and the various financial markets changed over to the euro in four days, the Governing Council of the ECB (formed by the six members of the Executive Board and the eleven governors of the National Central Banks) was able from its first meeting of the year to take its first decisions and to launch its first monetary policy operations.

The objectives of the ECB's monetary policy, which are laid down in the Maastricht Treaty, are ensuring price stability, and without prejudice to this primary objective, contributing to the general economic policy of the EU. Price stability has been defined by the Governing Council of the ECB as an increase of the Harmonised Index of Consumer Prices (HICP) of below 2% for the euro area as a whole from a medium-term perspective.

To reach this objective a strategy has been established that rests on two pillars. As there is a large consensus about the fact that in the medium term inflation is a monetary phenomenon, the Governing

Council has decided to adopt a reference value for the growth of a broad monetary aggregate, namely M3. The short-term relationship between money supply and prices being more complex to interpret, deviations of monetary growth from the reference value need to be addressed carefully. Beside this first pillar, the second is based on a large set of indicators, including inflation forecasts, wage developments and the exchange rate.

The Governing Council has proven its capacity to think and act for the euro area as a whole by its decision in April to cut the ECB's main refinancing rate from 3.0% to 2.5%, a historical floor. At that time production was slowing and inflationary expectations were going in a downward direction.

The cut has served its purpose. It has contributed to the resumption of growth. The rate of increase of consumer prices (1,2% in August for the annual rate of change in the HICP) is still well below the ceiling of 2%. Recent monetary developments (the growth of M3 and especially of credits to the private sector) signal, however, a rather generous liquidity situation in the euro area while with the acceleration of the economic growth the balance of risks to price stability is at present on an upward trend.

The Governing Council is monitoring the evolution closely and is now contemplating the appropriateness of modifying its interest rate. We don't envisage adopting a restrictive monetary policy stance, but rather a less accommodating one which would be better adapted to the new context. The goal is in any case not to hinder growth but to preserve its sustainability by the mastering of inflationary risks.

The euro area - and in particular Belgium - could perfectly enjoy, next year, a nice combination of strong economic growth and low inflation.

The integration of the financial markets

The integration of the European financial markets was one of the advantages expected from the introduction of the single currency. What can be said today?

As far as money markets are concerned, a very strong convergence of short-term interest rates could be observed by the end of 1998. After the introduction of the euro, the implementation of the operational framework for the single monetary policy and the new TARGET system have accelerated the creation of a liquid and integrated money market for the whole of the euro area. The speed at which the eleven national money markets have integrated into one single large market is remarkable. The TARGET system has allowed for a swift and efficient transfer of funds within the monetary union, thus reducing interest rate differentials between countries. The elimination of short-term interest rate differences was in turn necessary to enable the Eurosystem to conduct its monetary policy in an efficient manner in the entire euro area. The success of TARGET cannot be denied, not only from a technical point of view, but also from a commercial one as it has for the moment captured about 70% of the total volume of large value cross-border payments in the euro area.

Although it started earlier, the process of integrating bond markets will take longer. The impact of the single monetary policy is indeed slighter on these markets and national characteristics - in particular different tax regimes - still remain important. However, the disappearance of the exchange risk, the harmonisation of market practices, the redenomination of government debt into euro at the beginning of the third stage of EMU and important issues of government bonds in euro have contributed greatly to accelerate the process. Yet this has not led to the disappearance of interest rate spreads between countries. The European bond market is, as you know, largely dominated by the national Treasury departments which still place the major part of their issues on their domestic markets. While one has witnessed a decreasing spread between interest rates as a result both of the commitments made within the stability and growth pact and of the disappearance of the exchange risk, differences due to the size, liquidity and to the specific risk of each sovereign issue, however, still remain.

Though the European market of government bonds still suffers from a certain segmentation, the corporate bond market has already at present exceeded all expectations. During the first six months of this year, European companies are said to have issued more than double the amount registered in 1998.

Moreover, the average size of these issues has increased considerably. This evolution results from financing needs arising from Mergers and Acquisitions' activities, but first and foremost from the enormous potential the private bond market represents. It indeed benefits from the decrease in the financing needs of governments, from the disappearance of exchange risk and from the advent of a large, more liquid and more homogeneous European bond market. European companies will therefore turn more and more directly to the financial markets. The increased demand of companies for new ratings is another example of the growing interest of the large European companies to issue securities rather than to make use of traditional bank credits (a development which, as you know, will have implications for the banking sector).

Among the issued securities there are bonds, but also shares, and the introduction of the euro should foster the convergence and the progressive integration of the equity markets of the euro area. Things have evolved, but sometimes at a slower pace than had been hoped. Since the beginning of this year investors have indices at their disposal that are aggregated for the whole of the euro area. Several sometimes competing projects have emerged aiming to establish a common platform or to create links between stock exchanges to handle important European securities. These initiatives reflect the new perspectives monetary union offers. But a certain slowness and some hesitation also bear witness to the numerous obstacles that still check the stock markets' harmonisation and integration. However, the evolution that has started is unavoidable and will gradually lead to the formation of European financial markets whose size and importance as for the reallocation of resources will become comparable to the markets of the US. In this way one will see the differences subside that characterise the respective roles of banks and financial markets on both sides of the Atlantic in the collection of savings and the financing of investments. We should mention that while bank deposits are higher in the euro area than in the US, stock market capitalisation is four times higher in the US than the capitalisation of the sum of all the stock exchanges of the euro area. This transformation of the financial markets in Europe will become even more pronounced in view of the demographic evolution and the increased importance of pension funds and insurance companies as institutional investors.

The euro as an international currency

In such a context, the euro has not taken long to establish itself as an international currency.

At present the euro is the second most widely used currency, after the US dollar. The euro has of course inherited the weight of the former national currencies it replaces but its utilisation also stems from the economic importance of Europe in the world economy. With its 290 million consumers, the euro area is an economy similar in size to the US. GDP is lower than the one of the US, it contributes for a larger part to world exports. GDP of the euro area represents about 22% of world GDP, this is somewhat less than the US whose GDP reaches 29%, but considerably higher than Japan's GDP that stands at 13%. On the other hand the euro area is the largest commercial partner, with some 20% of total exports, against 16% for the US and 8% for Japan. The emergence of a European international currency is one of the results that was expected from the introduction of the euro and it is an obvious advantage for European companies. However, the Eurosystem has adopted a neutral stance concerning the international status of the euro. Its importance as an international currency will be determined by the markets.

To assess the international character of the euro after somewhat more than nine months, I will briefly go into the few functions usually attributed to an international currency. We can distinguish the official use of the currency and its use for private transactions. In the first instance, the euro can be used by public authorities as a reserve currency or as a pegging currency. Although no recent data are available on the relative share of the euro in the official reserves, one may suppose the euro to be the second reserve currency after the dollar, if one transposes the international weight of the currencies the euro has replaced. On the other hand the euro is used and will in all probability be even more used in the future as a pegging currency by some EU countries that have not joined the EMU, by countries of Central and Eastern Europe that are candidates for EU membership and by some other emerging countries. I would also like to mention countries such as Argentina, Brazil, Canada and South Africa which have issued international bonds denominated in euro in order to diversify their foreign debt to the benefit of the European single currency.

The international use of the euro by private operators can primarily occur within the framework of transactions or for investment and financing operations. At the beginning of the 90s one estimated that about 50% of the exports of goods and services was invoiced in dollars, one third in one of the currencies that participate in the euro and only 5% in yen. Although the part of the euro area in world exports is greater than that of the US, the euro will only assert itself progressively as a payment currency in international transactions. Indeed, the evolution of invoicing practices will be slow and will depend among others on the usual practices in the field of price setting on the international markets and in particular on the commodities and on the oil markets. The almost exclusive use of the US dollar stems from both custom and ease as these products are quoted in dollars, a fact which will not be easy to change. The international transactions denominated in dollars are therefore four times higher than US exports. While the relative share of the euro as a payment currency is bound to increase, this evolution will in all probability be slow and progressive.

As an investment and financing currency, the euro already plays an important part on international capital markets. During the first two quarters of this year, the share of euro denominated issues in the total of international issues has by far exceeded the aggregate part of its preceding currencies. In the first six months of this year, new euro denominated bond issues have surpassed by almost 50% the amount issued in the first six months of 1998 in the currencies that now participate in the euro. The international issues in euro now stand for more than 40% of the total amount issued on the international markets, which is a proportion that comes close to the one of US dollar denominated bond issues. Several factors which I have already referred to can explain this evolution: the financing of operations with regard to mergers and acquisitions, the bigger size and greater liquidity of euro markets and the euro issues undertaken by several major countries wishing to diversify the distribution of their foreign currency debt.

Given the international importance of the new currency, it is not surprising that the development of the euro exchange rate has attracted considerable attention despite the fact that the level of the exchange rate is less important for the euro area as a whole than it was for each of the participating countries before the start of EMU, in particular for a small country like Belgium. For this reason the level of the euro exchange rate is not in itself a precise policy objective of the Eurosystem. Nevertheless it is an important indicator in its monetary policy strategy.

In the first part of the year the relative weakness of economic activity in the euro area compared with the high growth in the US has affected the euro exchange rate. But now, with the good prospects for an economic upturn in the euro area, the firm commitment of the Eurosystem to internal price stability, which constitutes the best basis for the strength of the euro in the long run, is already better reflected in the external value of the currency.

Conclusions

The introduction of the euro stands for a profound and irreversible change in European integration. The euro did not only replace the participating currencies, it has given a new dimension to the single market by introducing changes in the structure of the European financial markets that now match the size of the single market. The euro has also made a promising start on the international capital markets and has contributed to a closer integration of European financial markets. Though these developments are certainly not complete they are impressive if one takes into consideration the short time covered. They show the confidence of European but also international investors in the soundness of the new European monetary policy based on the stability of the euro.

I add that the euro is not only the financial sector’s concern. For the non-financial sectors, the remaining part of the transition period before the permanent disappearance of the different national currencies offers companies the opportunity not only to change over to the single currency gradually, but also to reposition themselves in the new economic and competitive environment the euro area from now on represents.

Finally, for private persons new efforts should be made in the field of information and I wish that both on the European and on the national level the period to exchange banknotes and coins will prove a success and will reflect the European know-how as was the case during the changeover of the financial sector and the payment systems.

The baby is in good health. He is even sturdy for his age. He looks older than he is. But he has still to grow. For him life is only starting.