Mr Schieber takes a look at European monetary policy under the sign of the euro

Lecture delivered by Mr Helmut Schieber, Member of the Directorate of the Deutsche Bundesbank, in the context of the function "Germany – Powerhouse for Europe's Capital Market?", organized by Finanzplatz e.V. (Frankfurt), held in New York on 22 November 1999.

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I

I am delighted to have been invited to speak to you in the context of this function. It is, I believe, a rare privilege for a central banker to feature as a speaker at what is – ultimately – a marketing event. A well-known US central banker once said, however, that it is, in principle, always a mistake to invite a central banker as one's speaker, since he is not allowed to say anything that is of interest to his audience, while the audience mostly already knows everything that he is allowed to say. Today I shall try to get round that dilemma as best I can.

Figure 1

The launch of the euro - a milestone on the way to European integration

- The euro is a new currency which has superseded the old currencies in 11 of the 15 Member States of the European Union.
- 11 sovereign states, while retaining national responsibility for their fiscal and general economic policies, have set up a supranational central bank which bears the sole responsibility for the common monetary policy.
- The launch of the euro is associated with both political and economic expectations: politically speaking, with hopes of favourable repercussions on European integration; in economic terms, with hopes of further progress towards the enhancement of the common market through the disappearance of exchange risk and the intensification of competition.

The launch of the euro for 11 Member States of the European Union constitutes the most far-reaching change in the international monetary order since the collapse of the Bretton Woods system in 1973. For the first time, 11 sovereign states bearing continued national responsibility for their fiscal and economic policies have set up a supranational central bank bearing the sole responsibility for their common monetary policy.

The launch of the euro has aroused both political and economic expectations: politically speaking, the transition to the single currency marks a further – consistent – milestone on the road to European integration. In the meantime, the European Union comprises 15 Member States (the United Kingdom, Denmark, Sweden and Greece have failed to join the monetary union – for very different reasons); 12 other European states are seeking admission to the EU. In economic terms, it is hoped that the launch of the euro will likewise yield substantial benefits: it is anticipated that the disappearance of exchange risk within the Eurosystem and the intensification of competition in the European financial, merchandise and services markets will have a favourable impact on the further enhancement of the common market.

Don’t let yourselves be confused by the fact that the old currencies, such as the Deutsche Mark or French franc, are still in circulation in the 11 euro countries. Euro banknotes and coins will not be launched until the year 2002 because of the immense logistical trouble it will cause.

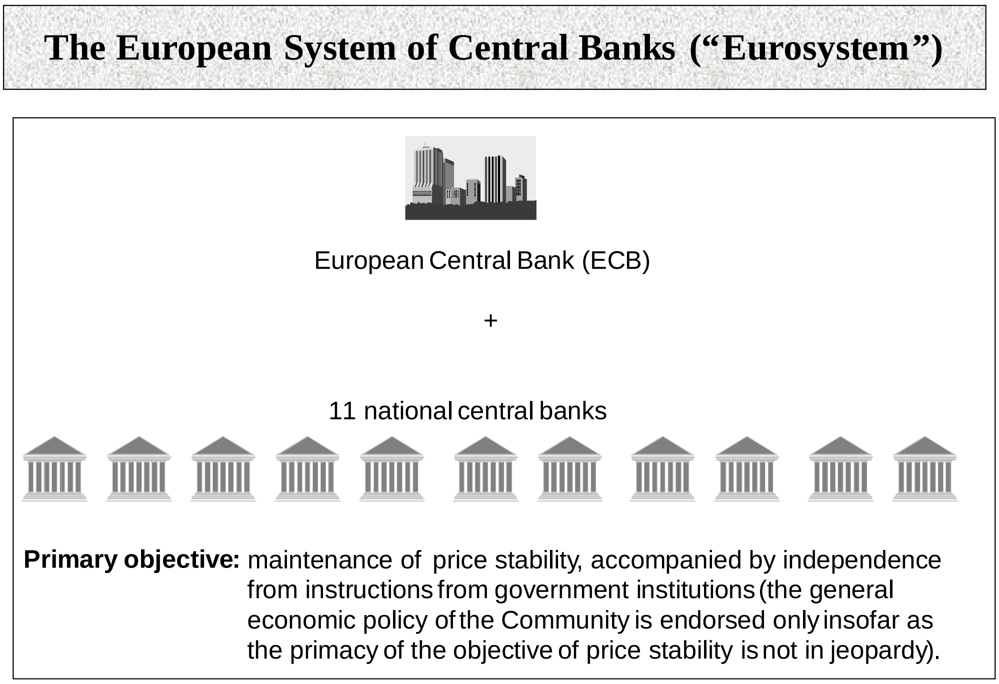
Actually, in statutory and economic terms, the euro is already the sole currency in the eurozone; the old currencies are – as we say in the jargon – nothing but the “non-decimal denominations” of the euro.

At this juncture, I have no wish to bore you unduly with figures. As regards the dimensions of the euro monetary area, it is enough to say that, in terms of their population and economic performance, the eurozone and the United States are roughly comparable (290 million EMU Europeans compare with 270 million US Americans; in terms of economic performance, the euro area, accounting for 15% of global GDP, is second only to the USA, at 20%).

II

The statutory and institutional prerequisites of the euro are laid down in what is known as the Maastricht Treaty.

Figure 2

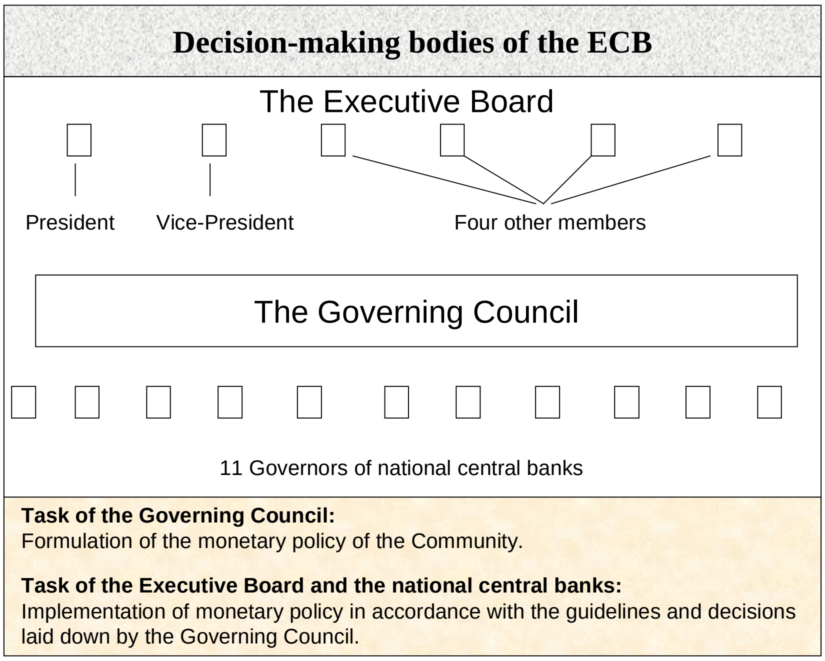


According to that Treaty, the so-called “Eurosystem” consists of the European Central Bank and the national central banks of the 11 Member States. Hence the Deutsche Bundesbank is integrated in the Eurosystem, rather than sunk – a small but significant distinction. I am not addressing you today as one of the last representatives of a species doomed to extinction.

The primary objective of the Eurosystem is the maintenance of price stability. That institution is independent of instructions from government bodies. It is required to support the Community’s general economic policy only insofar as that is possible without endangering the objective of price stability. That is a not entirely insignificant difference from the duties assigned to the Fed system.

The decision-making bodies of the Eurosystem are the Governing Council and the Executive Board. The Governing Council, comprising six members of the Executive Board of the ECB and 11 Governors of the national central banks, formulates the monetary policy of the Community.

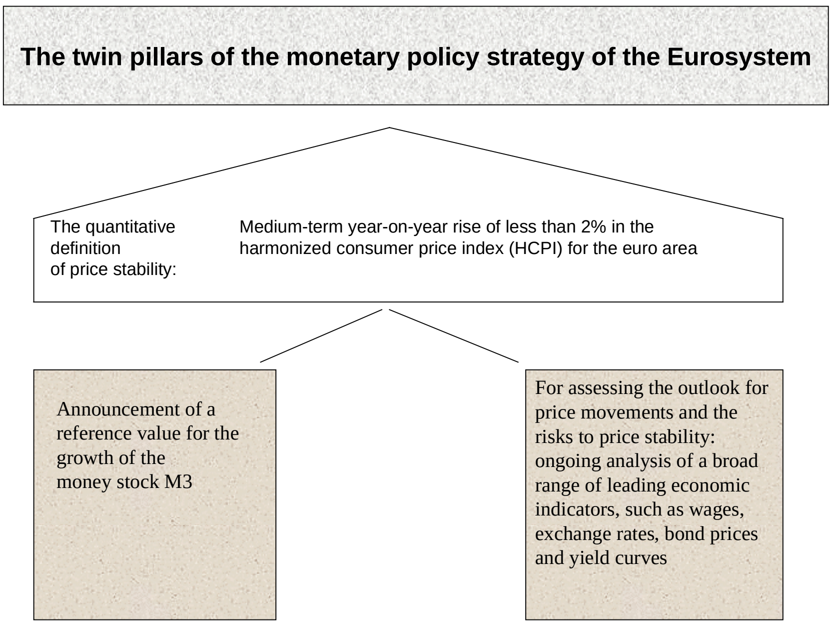
Figure 3



The principle of subsidiarity, as defined in the Treaty, is likewise important. According to that principle, the European Central Bank is required to avail itself of the services of the national central banks to execute transactions, insofar as that seems possible and appropriate. In practice, operational transactions are almost all conducted by the national central banks.

The monetary constitutions of the ESCB and the Deutsche Bundesbank show distinct parallels. The primacy of the maintenance of price stability is common to both systems, as is the high degree of monetary autonomy and the decentralized execution of duties.

Figure 4



ESCB monetary policy operations					
Monetary policy operations	**Types of transactions**		**Maturity**	**Frequency**	**Procedure**
	Provision of liquidity	**Absorption of liquidity**			
OPEN MARKET OPERATIONS					
Main refinancing operations	• Reverse transactions	-	• Two weeks	• Weekly	• Standard tenders
Longer-term refi-nancing operations	• Reverse transactions	-	• Three months	• Monthly	• Standard tenders
Fine-tuning operations	• Reverse transactions • Foreign exchange swaps	• Foreign exchange swaps • Collection of fixed-term deposits • Reverse transactions	• Non-standardized	• Irregular	• Quick tenders • Bilateral procedures
	• Outright purchases	• Outright sales	-	• Irregular	• Bilateral procedures
Structural operations	• Reverse transactions	• Issuance of debt certificates	• Standardized/non-standardized	• Regular and irregular	• Standard tenders
	• Outright purchases	• Outright sales	-	• Irregular	• Bilateral procedures
STANDING FACILITIES					
Marginal lending facility	• Reverse transactions	-	• Overnight	• Access at the discretion of counterparties	
Deposit facility	-	• Deposits	• Overnight	• Access at the discretion of counterparties	

Source: General documentation on ESCB monetary policy instruments and procedures, September 1998.

The Governing Council has defined its primary objective, namely that of maintaining price stability, in quantitative terms. According to that definition, price stability obtains if it is ensured over the medium term that the year-on-year rise in the harmonized consumer price index (HCPI) for the euro area is less than 2%.

To realize the objective of price stability, a monetary policy strategy which rests on two pillars was devised. In the first place, the Governing Council announced a reference value for the growth of the money stock M3; secondly, a broad range of leading economic indicators is constantly being analyzed in order to assess the prospects for price movements and the risks to price stability.

Central bank money is mainly provided through open market operations, a weekly tender being offered with a maturity of two weeks and a monthly one with a maturity of three months. Through the institution of two standing facilities, the movement of the overnight money rate is curbed by an interest-rate corridor, i.e. a ceiling and a floor to the overnight money rate.

The Eurosystem also has a wide range of fine-tuning instruments. Owing to the buffer function of the minimum reserve system, however, a comparatively steady development of the money-market rates is assured, so that the Eurosystem has not had to intervene in the market with fine-tuning measures even once since the start of monetary union. You can gather the full range of the monetary policy instruments of the Eurosystem from the figure; unfortunately, I am unable to go into more detail here, for time reasons.

In my opinion, the monetary policy strategy and arsenal of instruments of the Eurosystem are convincing and fully in keeping with international standards. The particular significance of the two standing facilities is demonstrated, for instance, in connection with the Y2K problem. The marginal lending facility sets the ceiling on the overnight money rate, since the counterparties of the ESCB can obtain overnight liquidity on an unlimited scale against the lodging of sufficient collateral. Unless I am much mistaken, the Fed has just set up a similar facility for the turn of the year.

III

Just under 11 months after the launch of the euro, it seems legitimate to take initial stock:

As regards domestic price stability, i.e. the movement of the inflation rate, the history of the euro has so far been a "success story". The rise in the harmonized consumer price index, currently at 1.2%, is still a good way off the absolute limit of "less than 2%" set by the Governing Council. Even so, increased vigilance is needed here since a certain upward pressure on consumer prices has to be expected, not least on account of the steep rise in oil prices. For this reason the Governing Council of the ECB decided at its meeting on 4 November 1999 to raise the ECB's three main interest rates by 50 basis points each. The Governing Council is convinced that the timely rise in interest rates will avoid the need for stronger measures later; on balance the prospects for sustained price stability remain good.

[**Figure 6**] – not available

"There is no light without shadows", says a German proverb, and that brings me to a topic which has been much discussed among the public at large, namely the movement of the external value of the euro:

The expectations about the positioning of the euro in the global financial markets were very mixed. "Euro over-optimists" had reckoned with a rapid appreciation of the euro against the US dollar because they were expecting central banks, institutional investors and private investors to take early and marked advantage of the euro in order to diversify their portfolios, which often focused on the dollar. By contrast, "euro sceptics" drew attention to the fact that it needs a long time before a new and untried currency is accepted as an investment, reserve and transaction currency.

As a matter of fact, the euro made a promising start in the foreign exchange markets, with a rate against the dollar of 1.18. But the exchange rate soon began to edge down, reaching an all-time low, at 1.0124, on 12 July.

The main reasons for this depreciation were no doubt the astonishing resilience of US business activity and the associated distinct interest-rate advantage of the United States.

In the meantime, the reference rate of the euro against the dollar has picked up distinctly, and for some time past has been moving within a range of 1.03–1.09 (on ... the current level is ...). This upward movement is undoubtedly due to the improved economic outlook and rising interest rates in the eurozone.

The movement of the external value of the euro can be viewed with relative composure from the standpoint of a European central banker. Since the euro became the single currency of 11 European countries, foreign trade between those countries has been conducted without any exchange risk or exchange-rate fluctuations. In other words, only foreign trade with non-EU countries is affected by exchange-rate movements; hence the "openness" of the euro-area countries, i.e. their vulnerability to exchange-rate fluctuations, has decreased significantly.

IV

What, then, have been the repercussions of the launch of the euro on the European financial markets?

Figure 7

Degree of integration of the European money market	
Unsecured money market: completely integrated	**Secured money market: making distinct progress towards integration, but certain deficits remain**
- highly liquid - with substantial transaction volumes - large proportion of "big player" trade nowadays cross-border - cross-border payments settled smoothly by the TARGET system	- divergent legal systems - cross-border settlement of securities transactions sometimes poses problems

To begin with, a few words on the European money market, i.e. the direct field of operations of the ECB.

As far as the unsecured money market is concerned, it has long been fair to speak of a single European market. In this sector, a highly liquid market with a tight bid-ask spread and considerable transaction volumes evolved very quickly. A large part of the trade between "big players" is meanwhile being transacted with counterparties abroad; this trend is undoubtedly being fostered by the smooth functioning of the European payment system, TARGET.

Distinct progress towards integration has likewise been made in the secured money market. Even so, there are still certain shortcomings here. Particular problems are posed by the coexistence of different legal systems, as reflected, for instance, in divergent master agreements. To cite an example, alongside the PSA/ISMA master repo agreement customary for international transactions, there are a number of national framework agreements, e.g. for Germany or France.

Finally, there is also a degree of friction in connection with the cross-border settlement of securities, as a result of which particular securities are being traded only in their domestic markets. In general, however, all those concerned are faring satisfactorily as far as the European repo market is concerned: for instance, the European Banking Association is in the process of preparing a European master repo agreement, which will be put on the market very shortly.

Figure 8

Degree of integration of the European capital market	
Bond market: largely integrated	**Equity market: some progress towards integration, but still no little need for adjustment**
- large-scale old issues converted into euro - uniform market practices laid down - highly liquid - world's second largest bond market after the USA	- segmentation of European stock markets (but: efforts to create a pan-European stock market) - national differences in corporate law, tax law and balance-sheet law

With reference to the European capital markets, it must be said that developments in the bond and equity markets have so far diverged very markedly:

In the market for fixed interest securities, a large and liquid market came into being very quickly after the disappearance of the price differences owing to inflation and exchange rate changes; in the meantime, the euro bond market is the second largest in the world, after the US bond market. The main reasons for that were, firstly, the decision taken by the principal issuers not only to launch new issues in euro, but also to convert fungible large-scale old issues into euro. Secondly, market players had agreed in the run-up to monetary union to standardize their highly divergent national market practices into internationally customary market rules and regulations.

I suppose that the formation of a single European equity market will take some time. It is true that efforts are now being made to set up a pan-European stock market, so as at least to overcome the pronounced segmentation of European stock markets, but national differences in underlying conditions – meaning corporate law, tax law and balance-sheet law – constitute a serious stumbling block to that.

V

Altogether, the chances of the further auspicious development of the euro financial markets are to be rated very favourable. The substantial progress towards integration that has already been made attests to the rapid pace of growth of the euro area; the attractiveness of the euro to international investors and issuers alike will probably go on increasing.