The Euro and Financial Markets: Challenges for Bankers and Policymakers

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1. Introduction

The introduction of the euro was an event of truly historical significance. The process of transition from the old regime to the new one was accomplished with outstanding skill and all of those involved deserve our congratulations. Yet, it must be said that great challenges, perhaps even greater challenges, still await bankers and policymakers if all of the possible benefits of this new regime are to be achieved while at the same time financial and monetary stability are to be maintained.

The euro will have significant effects in three principal areas. First, it seems likely to catalyse a sharp increase in competition within the European financial system. Such enhanced competition will surely increase efficiency and value for European consumers, yet it must also be said that competition also can be disruptive to the lives of bankers and others so affected and could lead to financial excesses of various kinds. Second, introduction of the euro has already profoundly altered the nature of European monetary policy and this will change significantly the environment in which European bankers operate. The objective of monetary policy is now price stability in the euro area as a whole, which means there can no longer be the same focus on national objectives for monetary policy. Moreover, since exchange rate changes are no longer possible within the area, firms (including those providing banking services) which allow themselves to become uncompetitive can no longer count on depreciation to help them out. In this new context, other policies to improve the functioning of labour and product markets must be given higher priority if profitability is to be restored. Finally, the introduction of the euro will have implications for the global financial system. With time, the euro may come to challenge the dollar as a transaction, reserve, investment and even anchor currency for other countries seeking the monetary and financial stability that it is hoped the euro will bring. This too will have important implications for the banking industry - both challenges and opportunities. Note, however, that an enhanced international role for the euro may also mean enhanced responsibilities for European policymakers.

In each of these three areas, there are positive implications but also some potential pitfalls. The focus in this paper will be on the steps required to ensure that the positive aspects prevail. This will only happen if both bankers and policymakers face the issues squarely. Implicit in facing issues squarely is also the need to make tradeoffs and sometimes hard decisions, but that is the essence of what both business and economics is all about.

It is also important to note that, while the introduction of the euro is surely a big event, it is not the only significant development happening in the world today. The effects of the introduction of the euro must be seen against a global backdrop. A first important point is that competition in the financial sector is not just heating up in Europe but everywhere. If Europe has the catalytic effect of the euro, Japan has the "Big Bang" and the United States has the end of Glass Steagall. Moreover, with most emerging markets opening up their financial systems, enhanced competition is now occurring on a truly global scale. A no less important point is that this enhanced competition in the global financial sector is taking place against a troubling backdrop of continuing macroeconomic imbalances in the global economy. The current cyclical divergence between the United States and Japan is unprecedented in the post war period, and there are current account imbalances to match. Stock prices in many countries seem hard to justify in times of potential future earnings, while recent low commodity prices have had devastating effects on many emerging markets. In Africa and Latin America, for example, many countries already in deep recession nevertheless have current account deficits large enough to threaten prevailing exchange rate levels.

It is finally worth noting the possibility that increased competition in the financial sector could interact with these macroeconomic imbalances to produce disinflationary effects greater than the sum of the parts. The bottom line is that policymakers in Europe still face serious challenges in pursuing competitive financial markets and monetary stability. Moreover, given the size and global importance of Europe, policy solutions must in many areas be negotiated with other international agents, which will add a further layer of complication to what are already complex issues.

2. Challenges in fostering competitive financial markets in Europe

The European financial system has many great strengths. Relative to the English speaking countries, there has been much greater reliance on intermediated lending and ongoing relationships between borrowers and lenders. This system has generally proved strong and stable, albeit at the cost of certain inefficiencies and a low level of innovation. However, many new forces are emerging which seem likely to sharply increase competition in the provision of financial services in Europe, whether one likes it or not. What are these forces? There are many and they may well interact in ways that are difficult to predict.

Perhaps the most important force for change is technological change, which is generating many new products as well as new ways of delivering them. Indeed, as information costs come down in light of technological advances, "relationship banking", which is based on insider knowledge and is at the heart of the European financial system, may be greatly challenged. In the limit, the Internet could turn the established branch banking system from an asset into a liability. Technology also lowers entry costs implying that the competition faced by European financial institutions may be considerably enhanced by a whole host of non-European financial institutions (especially from the United States) as well as unregulated non-banks (from Marks & Spencers to General Electric). It is important to recognise the primacy of these technological forces driving change since, because technology tends to diffuse very rapidly, they will be extremely difficult to resist.

Two other related forces for change may be of special importance in a European context: the changing role of the state and changing demographics. The state has traditionally played a great role in the provision of financial services in Europe, but this is now being challenged in various ways. State owned banks and even mutual associations, supported by the state in various ways, are being attacked as "uncompetitive" by their private sector counterparts, particularly in Germany. And such accusations seem sure to become more shrill and more widespread as financial firms start to expand across borders to exploit the "single passport" provisions of the Second Banking Directive. Closely related to the role of the state is the changing influence of demographics. As the fiscal burden of state pension schemes becomes increasingly evident, private savings for pension purposes are rising. Such savers are likely to demand higher rates of return than traditional banking institutions can provide and may also be willing to use new technology to help them manage their own assets without the assistance of financial institutions. Use of the Internet has the potential to make the life of "middlemen" everywhere distinctly uncomfortable.

The introduction of the euro will also significantly enhance competition. Two principal channels can be identified. The first is the likelihood that European securities markets will become bigger, deeper and more liquid. Indeed, this is already happening and security issuance will provide meaningful competition to traditional banking relationships. While it is true that banks will get a significant share of this business (since syndicated loans can be securitised and underwriting can be profitable), economies of scale imply that only a few firms will be able to prosper in this way. The second principal channel will be the increased transparency of pricing across borders. A combination of this transparency and new technology will eventually enhance international competition at the retail level. While significant penetration will likely take some years, institutions wishing to survive and prosper should be certainly thinking about the future.

A final factor leading to enhanced competition is the growing concern for shareholder value. The role of shareholders is becoming more influential given the trend to international share ownership and the growing incidence of hostile takeovers in continental Europe. Clearly, if shareholders are demanding higher profit levels, even as profits are under pressure for all the reasons I have just noted, the potential for quite radical change in the financial landscape would seem evident. This brings me on to the issue of the potential benefits and the potential costs of such a process.

The benefits of enhanced competition in the provision of financial services in continental Europe will be very great, both for consumers and for businesses. Many studies have convincingly shown that the costs of financial services in Europe are far higher than they should be and these costs will come down with more competition. Access to new products and products tailored to the needs of individual consumers should also increase significantly. The pricing of credit risk in Europe also seems less well advanced than in some other countries, implying that some firms receive more favourable, and others less favourable, terms than they should. This in itself contributes to a misallocation of capital with significant costs to the real economy; it is a well documented fact that the rate of return on capital in Europe is significantly lower than in the United States. A more competitive financial system should in principle allocate credit better, with new firms and those seeking finance for the first time receiving particular benefits. It is worth noting in this regard that, in North America, it is precisely these sorts of new companies which have been responsible for most of the impressive growth in jobs over the last decade. In sum, the benefits of a more efficient financial services industry will be felt far beyond the confines of the financial industry itself.

Yet, if more competition will bring great benefits, there are associated dangers as well which policymakers should recognise and take steps to mitigate. Perhaps of greatest importance, financial institutions under strong competitive pressures may take on excessive risks in order to maintain or even increase rates of return on capital. This has been a recurring feature of financial behaviour for centuries and there is no reason why it cannot happen again in Europe today. Indeed, we may already be seeing some aspects of such behaviour in the fact that European financial institutions are the predominant lenders, by far, to emerging market countries in each of Asia, Latin America and East and Central Europe. And even within Europe, some central banks have in recent years had to warn their banks about the dangers of expanding loans at margins too thin to account for the risks being undertaken.

What are the principal policy issues involved if a better tradeoff between costs and benefits of increased competition is to be achieved? In particular, how can the European financial system be slimmed down and rationalised, while at the same time avoiding disruptions and even financial crises along the way. A number of pertinent questions immediately come to mind, even if the answers are not so evident given the need to balance often conflicting arguments and influences. Let me just note five of the more important questions.

1. How quickly, if at all, should the state withdraw from direct involvement in the financial services sector? This includes, not only direct state ownership, but also indirect support of various sorts.

2. If a natural part of the process of competitive restructuring in the financial services industry will be job losses, how actively should the state resist this process? Job losses in the financial industry itself are obviously unfortunate. Yet, an unrestructured and unprofitable financial system could potentially lead to even more job losses in other industries. One route, seen recently in Japan, would be for the financial industry to sink slowly into a state of lethargy and credit rationing which could seriously impede the real economy. Another route, seen in the 1980's Savings and Loan crisis in the United States, would be for a weakened industry to "gamble for resurrection" by taking on ever riskier loans. The costs to the real economy and to job creation would then become evident only when the bubble burst, likely taking a large number of financial firms down with it.

3. What should be the attitude to domestic mergers or takeovers? Will they increase efficiency or rather reduce competition, particularly at the retail level? In this regard, how potent a force will international "contestability" be in reducing the danger that consolidation among large national banks will lead to national monopolies capable of exploiting their dominant position?

4. What should be the attitude to international takeovers or mergers? On the one hand, they may offer potential for pan-European efficiencies. On the other hand, they may complicate crisis management by national authorities should such an institution fall into trouble.

5. And finally, speaking of crisis management, are there special problems likely to arise from having the supervision of financial institutions at the national level while the European Central Bank is an independent, supranational institution? In particular, the issue of timely information-sharing between all interested parties needs to be addressed. This is an issue of importance to Europe but, given the globalisation of financial markets, is currently of considerable interest to public authorities in other countries along with international financial institutions (including the BIS) interested in promoting international financial stability.

3. Challenges in fostering monetary stability in Europe

The introduction of the euro has altered the pursuit of monetary stability in Europe in significant ways. Most profoundly, there is now a single ECB interest rate and exchange rate which applies to all countries. The microeconomic and political benefits of this cannot be over-estimated. The intertwining of national economies should support both a more efficient production structure in Europe and the cause of peaceful coexistence more generally. Yet, as with the pursuit of financial stability, some of the complications and potential pitfalls associated with the introduction of the euro also need to be acknowledged and addressed.

Let me begin by listing some of these issues before going on to consider possible policy responses.

One problem with having only a single policy rate is that different countries within the euro area may find themselves simultaneously at different phases of the business cycle. Thus, whatever interest rate is chosen by the ECB may be appropriate for some countries while being inappropriate for others. The contrast between recent and prospective economic developments in Germany and Italy on the one hand, and (say) Spain, Portugal and Ireland on the other, shows that this is not just an academic issue. Should national production structures in Europe become increasingly specialised (like Silicon Valley) this problem of non-synchronous cycles might become more serious with time, although I admit that the very opposite could also happen. The capacity for asset prices to exacerbate regional differences is another potential complication. In the cyclically advanced countries in the euro zone, residential property prices have risen about 40% since the beginning of 1996 whereas elsewhere in the euro zone they have essentially stayed flat. The biggest danger arising from these so-called "asymmetric shocks" is that policy might become excessively influenced by the needs of the slowest growing regions. This would obviously lead to an unwelcome inflationary bias in the region as whole. Recent movements in policy rates in the euro zone indicate this will not be a practical problem in the short run at least.

A second complication is that different counties may respond differently to movements in the single interest rate and exchange rate. With respect to interest rates, businesses in some countries rely less (some more) on shorter-term versus longer-term financing. Some countries rely more than others on credit rationing devices, and in some countries bank loan rates move relatively slowly when policy rates change. Borrowers in different countries may also have different debt levels, which means they are more or less exposed to interest rate increases. In Belgium and Italy, for example, higher rates have large effects on fiscal deficits which could feed back in various ways to banking systems which have invested heavily in government debt. The implication of these observations is that changes in policy rates may affect some countries more than others. In a similar vein, it is worth noting that changes in the value of the euro may have bigger effects on some countries than on others. Italy and France, for example, are relatively more reliant on trade with countries outside the euro zone than are Germany and the Netherlands.

A third complication arises from the fact that the introduction of the euro is intended to increase competitive pressures and, in turn, foster structural change. Should this happen, as we hope it will, a corollary would be that the transmission channels through which monetary policy affects the economy would themselves be changing. This adds a further dimension of uncertainty to the conduct of monetary policy. Perhaps the most obvious example of this kind of process will be prospective shifts in the demand for money, a complication implying that less reliance can be put on movements in the money supply as an indicator in the conduct of monetary policy. The most likely outcome will be a downward shift in the overall demand for money balances as firms consolidate their euro accounts across countries which previously had different currencies.

And finally, and most obviously, exchange rate changes can no longer be used to restore or increase competitiveness within Europe. Until recently, an Italian audience might have felt this constituted a problem since, being traditionally a high-inflation country, it could no longer resort to major real depreciations at the expense of (say) German exporters. In the last few years, however, as inflation has become more equal across Europe, the implications of other domestic practices (in particular, taxes) for competitiveness within the euro zone have become clearer, and it is becoming more widely understood that investment within the community will increasingly be determined by such considerations. Indeed, it is already the case that Germany attracts proportionately less foreign direct investment than other European countries which may not be a good omen for that country in the future.

If the introduction of the euro has some downsides to partially offset the dominant upsides, the good news is that the impact of the former can be significantly reduced by the adoption of countervailing policies; that is, policies which will make it easier to maintain monetary stability in the euro zone while still achieving high rates of growth and low levels of unemployment. Consider first problems arising from asymmetric shocks and the impossibility of their being nominal exchange rate changes within the euro area. The fundamental answer to this problem is that domestic prices and wages must become more flexible, and there must be a greater willingness to allow wages to differ across countries to reflect differences in national labour markets. Seen from this perspective, suggestions for pan-European wage setting would likely be a recipe for sharply higher unemployment. The international migration of labour from high unemployment to low unemployment areas should also be encouraged, though I do recognise this also raises social and political as well as economic issues. Finally, if national circumstances differ, but monetary policy cannot be used differently across countries (and with a single currency it cannot), then differential fiscal policies might also have a role to play, subject of course to longer-run concerns about fiscal sustainability. For countries that already have heavy debt levels, and will thus have significantly less room for manoeuvre with respect to fiscal policy, labour market reform will be especially important. I cannot stress this point too strongly, particularly being here in Italy.

Given a single interest rate, it is not at all obvious what might be done to prevent asset price increases of the sort currently being observed in the cyclically advanced countries in the euro zone. Indeed, it is not at all obvious how the ECB should react were there to be a more generalised asset price bubble within the community. The biggest danger arising from asset price bubbles is that their eventual collapse will do serious harm to the national banking system, as seen in the early 1990's in Scandinavia and more recently in Mexico and East Asia. Fortunately, as banks and other financial institutions increasingly diversify their portfolio across the whole of Europe, their exposure to regional problems of this sort should be reduced. Thought should be given to ways in which such diversification might be encouraged, including the issue of cross border mergers and acquisitions. As an aside, the same can be said for the holdings of national government bonds by national banking systems. These bond holdings should also be more diversified to hedge against the possibility that sovereign credit risk differentials (particularly for countries with large government debts) might at some point widen from current low levels.

The fact that different national economies will react differently to changes in the single policy rate and the single exchange rate is simply a fact of life to challenge the policymakers in Frankfurt. While some harmonisation of national financial structures may be expected to ease this problem over time, it will never go away completely as national economic structures will always differ in some regard. As for the complications posed to the conduct of monetary policy by the structural changes induced by the introduction of the new currency, with time these changes will effectively end or will at least become more predictable. Again by way of example, the demand for money function should eventually stabilise in the euro zone implying that the ECB may be able to rely more heavily on a monetary targeting approach to the conduct of monetary policy rather than the more eclectic approach currently being followed.

4. The euro and challenges in managing the global financial system

With the introduction of the euro, the international financial system is now divided into two principal zones: that of the dollar and that of the euro. This raises questions of substance concerning movements in the euro-dollar exchange rate. In particular, is there likely to be more short run volatility than previously, and are medium-term swings in the exchange rate likely to be more exaggerated and potentially more disruptive than in the past? The introduction of the euro also raises a number of interesting questions of process. Who speaks for the euro in international fora, and is the dynamic of decision making likely to change given this new environment?

Consider first the issues of economic substance. The dollar zone and the euro zone are both huge and essentially closed; that is, most trade is within the zone itself. Since this means currency movements have less impact internally, the authorities may have more of a tendency towards benign neglect which could lead to more short term exchange rate volatility than hitherto. Having said this, because the dollar is more at the centre of a zone than is the euro, the European authorities will have to take a closer interest in the impact of exchange rate changes on domestic spending and prices than has been traditional at the Federal Reserve.

As for the possibility of medium-term swings or "misalignments" in the value of the euro, prior to the recent bout of euro weakness, attention was focussed primarily on the likelihood of a medium-term appreciation of the euro and the possible unfortunate implications for European competitiveness and jobs. Broadly put, there was a feeling that the euro would be used increasingly for international transactions (invoicing and currency trades), for official reserve holdings, for private investments and as an anchor for other currencies. This feeling that the use of the euro would grow reflected the contrast between the almost equal sizes of the US and European economies and the vastly larger role played by the dollar internationally as compared to the constituent currencies of the euro. As well, there was a sense that European financial markets in euros would grow broader and deeper and that this would be a catalyst for the use of the euro in many different ways. Indeed, in the last few months we have seen significant pieces of evidence that this is happening, not least the explosion of euro-denominated bond issues (albeit mostly by euro zone residents) in all categories of credit risk.

Much of this discussion of the future value of the euro has been misdirected. While some of the developments suggested above might put upward pressure on the value of the euro for a time, it must be recognised that there are forces working in the opposite direction as well. In particular, the decision to issue liabilities in euros acts to lower its value, just as the purchase of euro assets raises it, and (as just noted) we have seen enormous increase in the issue of such euro liabilities in the last few months. Moreover, and still more pertinent, portfolio shifts of this sort have only a minor influence on exchange rate values compared to the expectations of those holding assets in dollars and euros as to what the exchange value should be. These expectations will ultimately be conditioned by relative cyclical positions, the policies being followed on both sides of the Atlantic and, possibly in increasing measure, the growing weight of external assets (in the European case) and external liabilities (in the case of the United States). You would need a braver man than me to forecast how all these various forces will play out both in the near term and over time.

The process questions concerning the euro are also very interesting. Within Europe, it is a fact of life that the pursuit of domestic price stability by the ECB means that it cannot at the same time pursue some other objective, such as exchange rate stabilisation. With one gun there can only be one target. However, starting as far back as the beginning of this year, some prominent figures seemed to dispute this fact by suggesting that the ECB should take steps to either strengthen the euro, presumably to enhance credibility, or to weaken it to improve competitiveness and job opportunities. I will not go into the economic merits of these conflicting suggestions, but rather wish here to emphasise a point of process. Political interventions concerning the value of the euro, particularly conflicting ones, threaten to sow confusion and create market instability. More important, such interventions could alter both public and market perceptions about the independence of the ECB and in the limit destroy it. Given the great care that has been taken to establish its independence, it would be a tragedy if it were to be compromised inadvertently.

At the international level, the introduction of the euro raises still further issues about international financial cooperation. In discussions concerning the euro, say at the G7 or the G10, which Europeans should be represented and who should ultimately speak with authority? What is to be the role of the ECB, as opposed to representatives of the national central banks, and what are to be the relative roles of the central banking and Treasury communities? If there are to be fewer Europeans in some fora, will this make it easier to more closely involve systemically important emerging market countries in international discussions? If so, how might this best be done? These process questions are perhaps the most difficult of all, and I know they are currently being actively discussed in European circles.

Yet, it must also be recognised that the answer to many of these questions is not something that Europeans can unilaterally decide. In the first place, international financial cooperation in our modern world must take place on a truly global scale with the involvement of all countries of systemic significance. Process issues arising from the introduction of the euro and recent discussions about the international financial architecture are thus intimately related. In the second place, it must be realised that the particular way that Europeans are represented in international meetings will have a significant effect on how those meetings are conducted, the dynamics of decision-making and issues surrounding global leadership. Needless to say, Europeans are not the only people interested in such questions.

5. Concluding Comments

The global economy is evolving rapidly. Emerging and transitional economies are involved in immense economic restructuring, while liberalisation and deregulation characterises many industrial countries as well. While now much more efficient and productive than it used to be, the global economy also gives indications of having become commensurately less stable. The global financial system is also becoming increasingly competitive and potentially prone to excesses, while a number of macroeconomic balances also threaten to undermine global stability. Here in Europe, the introduction of the euro will certainly bring great political and economic benefits with time, but it has also brought short-term complications into the life of policymakers. The competitive pressures the euro seems likely to catalyse in European banking and financial markets will also prove extremely challenging to many of those in this room today.