

The euro in the international capital markets

Opening address delivered by Eugenio Domingo Solans Member of the Governing Council and the Executive Board of the European Central Bank at the Euro Capital Markets Forum - "Dawn of a new era" Marriott Hotel, Frankfurt/Main, 15 April 1999

Allow me to begin by stating that I am convinced that the euro will play a decisive role in the world economy and in the international capital markets. I will divide my speech in three sections, which I hope will serve to explain why I am convinced of the above.

Factors behind the euro's role as an international currency

There are three main conditions for a currency to acquire an international role.

First, it will depend on what we might call the "habitat" of the euro, that is to say the relative demographic and economic importance of the euro area, which forms the basis on which the currency is supported. In this respect, it is not only its present importance which is relevant, but also its foreseeable future trend. Moreover, linked to the monetary habitat, we should also consider the degree of openness of the economy, in the sense that this provides us with an idea of the number of commercial transactions of an area compared with the rest of the world economy.

Second, the financial dimension is of fundamental importance in order to evaluate the impact of the euro in the world. By financial dimension, I am referring to the degree of development and the level of activity of the European financial markets and institutions, in terms of volume, diversity of business, and degree of integration. Like the volume and diversity of business, the degree of integration of financial markets constitutes a factor that magnifies the external impact, and is, therefore, a fundamental element in reinforcing the role of the euro as an international currency.

Finally, the global importance of the new European currency is also linked to the confidence inspired by the euro and the European Central Bank (ECB), which, in turn, depends on whether stability is achieved as well as on the transparency and degree of accountability of the institution determining monetary policy.

The consideration of these three factors gives rise to the conclusion that the euro area will, from the outset, play a decisive role in the world economy, comparable in certain aspects with that of the US dollar, naturally being capable of significantly affecting international economic relations and - more importantly - having great potential for future development.

The initial situation of the euro as an international currency is, in conclusion, solid.

Expected future trends

Apart from this encouraging, but incipient, base, how will the euro perform as an international reserve currency? It can be ventured that, in an initial phase, the international role of the euro will be greater as a currency for financial investment by market participants and as a reserve currency for central banks, than as a vehicle for the exchange of goods and services in the world economy. That is to say, the euro will be more used internationally as a store of value than as a medium of exchange.

There are reasons to believe that private investors will have a tendency to increase the proportion of their portfolios denominated in euro in comparison with their holdings in the 10 currencies which form the basis for the single currency. The solid economic base supporting the euro, the confidence in its stability and in the monetary policy of the ECB, as well as the increasing development and integration of the up to now fragmented European monetary and financial market, are the principal factors confirming such a belief.

The integration of the European monetary markets relies, of course, on the existence of a single refinancing system for banks in the euro area, that is to say on the common monetary policy. But it also relies technically on a system of instantaneous data transfer and on the new common payments system, TARGET, enabling real-time gross settlements. Thanks to the smooth functioning of the information, communication and payments systems, a common monetary policy is a reality and the full integration of money markets can take place. Such integration will, in turn, imply greater liquidity and a further development of the financial markets.

A specific channel through which the monetary policy of the ECB can have a direct impact on the development of the financial markets of the euro area derives from the requirement to have adequate collateral for operations with the ECB. This requirement, especially in the case of certain financial systems in Europe, can stimulate the process of loan securitisation. In addition, collateral can be used across borders, which means that a banking institution in a country belonging to the European System of Central Banks (ESCB) can receive funds from its national central bank by making use of assets located in other countries. This should clearly have a positive impact on the integration of financial markets in the euro area.

The trend towards further integration of the European financial markets, together with the increased use of the euro as a vehicle for international investment, should logically follow a process which would start in the short-term money market, subsequently be expanded to the longer-term money market and then reach the public and private bond and equity markets. In the short term there must be a tendency for the differentials in money-market interest rates to be eliminated, while, in the long-term, interest rates on securities markets - both public and private - will always include a risk premium, linked to the degree of solvency of the country (deficit and public debt, commitments on pensions, etc.) or to the credit risk of the private company issuing the loan, as well as the liquidity of the securities.

As a medium of exchange for the trade of goods and services, the euro will possibly develop more slowly and will need time to achieve a situation comparable with that of the dollar. The

American currency has a dominant position in this respect and there is a tendency for its use to be reinforced because of economies of scale. Just as it took decades for the dollar to substitute the pound sterling as a vehicle for international trade, it will also take some time for the euro to reach a position where it is playing a role comparable with that of the dollar. This will depend, in any case, on the different markets (the dollar is proportionally more rooted in the derivatives exchanges) and the different geographical areas (Eastern Europe and North Africa will be more "euroised" regions and Latin America more "dollarised").

In any event, it is important to emphasise that the ECB will not adopt a belligerent stance to force the use of the euro in the world economy. This will take place spontaneously, slowly but inexorably, without any impulses other than those based on desire and the free decision of the market participants, with no logic other than that of the market. It is certainly the case that advantages are gained from the international use of a currency, such as income from seignorage, but there are also disadvantages, such as the complication of the formulation or implementation of monetary policy.

Instead of establishing exchange rate fluctuation bands, European experience has shown that certain good common macroeconomic fundamentals represent the best strategy for achieving a better co-ordination of exchange rates.

First trends since the introduction of the euro

You will probably agree with me that 100 days are not enough to identify broad trends and structural developments related to the introduction of a new currency, especially if this currency is the legal tender of an economic region of the dimensions of the euro area. However, some interesting facts have already been observed and several positive signs can be identified.

The one I consider most favourably surprising is what I would call "normality". During this period there has not been sharp volatility in the exchange rate of the euro against major currencies, the money markets have worked smoothly and there have not been too rapid or too large shifts in the share of financial assets denominated in euro.

As regards the exchange rate, the euro has gradually depreciated from the beginning of the year, but volatility has been small compared to what was expected for a new currency. In any case, if you compare the present exchange rate of the euro vis-à-vis the dollar with the 1998 average of the so-called synthetic euro, you will realise that they are similar.

On the money market, which is an area more clearly linked to the ESCB's direct responsibility, the sudden transformation of the eleven euro-area domestic markets to the new situation took place in a fast and smooth way, notwithstanding the large differences in practices that existed. An indication in this respect is the reduced dispersion of overnight interest rates among participating countries as well as the high turnover in the overnight market.

The first developments in the repo market have also been quite satisfactory. The transition has been smooth in general terms, and major problems which could have disturbed the transition have been avoided. Examples of such potential problems are related to securities redenomination, methodological changes in the calculation of accrued interest, and clearing and

settlement procedures. In any event substantial developments in the main factors promoting the integration of the euro-area repo market are to be expected over the medium term. These are, among others, changes in securities trading and custody systems. In any event, the repo-based implementation of the ESCB's monetary policy is already playing a major leading role in this respect.

In addition to the money market, the government bond market is the one where the impact of EMU has been more visible from the very beginning. In fact, some of the changes already started before the introduction of the euro. Yield spreads prevailing between the various euro area government bonds were substantially reduced and, in several aspects, coordination among participating national treasuries developed at a fast speed. A landscape of co-operation and competition among national treasuries is developing; this will eventually be reflected in more efficient and integrated euro government bond markets.

As regards the private bond market, the share of financial assets denominated in euro has steadily increased since the beginning of the year. The share of bond issuance denominated in euro is now 44.1%, practically reaching the level of dollar-denominated bond issuance (44.9%). This outcome is again more satisfactory than previously expected.

It may be useful to add that the driving force behind the increased issuance is the private sector, given that government deficits are limited and trending structurally downwards. It also appears that foreign borrowers, especially US ones, are contributing substantially to the increase in euro-denominated issuance. This shows that the opportunities offered by the euro for portfolio diversification and arbitrage are being exploited by the markets.

In conclusion, from the first trends since the introduction of the euro, one may state that "normality" has been the key characteristic of this transition process, and probably the most warranted one. The impact of the introduction of the euro has been stronger on the markets which are closer to monetary policy, especially the money market, but the government and private bond markets have also been positively affected.

These favourable developments in the euro financial markets and the good performance of monetary policy enhance each other.

Both market participants and monetary policy makers will benefit from these positive first experiences of the euro. I am convinced that they will last.

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