THE EURO'S CONTRIBUTION TO THE FINANCIAL SYSTEM AND GLOBAL STABILITY

INTERVENTION BY SIIM KALLAS, AMSTERDAM, 12 OCTOBER 2004

Ladies and Gentlemen,

It is a great honour for me to chair such a distinguished panel of experts for this session of the conference. In our session, the debate will shift from the internal functioning of EMU and will focus on the more external aspects.

To help us understand the evolving international role of the euro, I am delighted to welcome Richard Portes, Professor of Economics at the London Business School and President of the Centre for Economic Policy Research. He will speak about a new "tri-polar" monetary system for the global economy and consider some of the many challenges involved. I would also like to welcome György Szapári, Deputy Governor of the National Bank of Hungary. He will speak about what the euro means to the newly acceded Member States and about the road to enlargement of the euro area. This is certainly a brilliant panel and we can all look forward to enlightening presentations and an interesting discussion.

To start, however, I would like to offer some views of my own.

The introduction of the euro was the biggest change in the system since the end of the Bretton-Woods framework in the early 1970s. It was a path-breaking experiment in responding to the problems of exchange rate management in a uni-polar international financial system. It has rapidly emerged as a major currency and - potentially as a pillar of a future multi-polar international monetary and financial system.

The evolving role of the euro as an international currency requires strength at home. Strength at home means having a robust economic policy framework to underpin the internal value of the currency. So let me first briefly recall the "domestic" strength of the Euro, and I will then turn to the global role.

Strength at home

An obvious benefit of the euro has been a more integrated and efficient EU financial system. Prior to the euro, the process of financial integration had been underway for nearly half a century. But, a Single Market in financial services remained an aspiration rather than a reality. In a modern financial system – where trading is high frequency and profit margins are narrow - transaction costs determine the level of activity. Until January 1999, the exchange-rate risk associated with the use of multiple currencies imposed additional transaction costs on cross-border financial activity. These additional transaction costs made cross-border activity unattractive and effectively put a brake on the financial integration process.

The euro has eliminated exchange-rate risk in the bulk of cross-border financial services within the EU and the demand for cross-border services has increased. In this way, the euro has paved the way for a more integrated EU financial system. But, at the same time, it has highlighted the opportunity cost of the remaining sources of fragmentation. In consequence, efforts to complete the Single Market in financial services have moved to the top of the EU policy agenda – notably with the implementation of the Financial Services Action Plan.

Why is EU financial integration so important for policymakers? The obvious response is because it is crucial for increasing the growth potential of the EU economy. Various economic studies have highlighted the link between long-term economic performance and financial development. Within the EU, financial structures are generally efficient at the national level but combine inefficiently. So, fragmentation remains the major source of inefficiency.

Where are we now, nearly six years after the introduction of the euro? I don't want to expand too much on the topic of this afternoon's session, so I will confine myself to a very general overview. Evidence suggests that the EU financial system is becoming more integrated, but integration is progressing unevenly across financial sectors. It is stronger in the case of financial products with agreed definitions, common conventions and common infrastructure. The most dramatic example is the unsecured money markets, which became immediately and fully integrated with the launch of the euro.

Progress in integration has been slower in EU securities markets, which are still fragmented by differences in national practices, taxation, and legal frameworks. The Financial Services Action Plan has already gone a long way toward addressing these differences. But, the remaining sources of fragmentation must be addressed in the coming years if a Single Market in financial services is to be delivered.

The economic benefits of financial integration cannot be delivered without appropriate flanking policies, and in particular policies to safeguard financial stability. While integration would benefit the Member States by being part of a larger financial bloc, it is essential that this integrated EU financial bloc should be inherently stable. Financial integration will intensify the risk of contagion from one country to another, due to the increased cross-border linkages. Only an appropriate regulatory and supervisory framework can contain this intensified contagion risk.

The Financial Services Action Plan includes a number of actions aimed at enhancing the framework for prudential supervision in the EU. More generally, it will reinforce the safeguards for financial stability by paving the way for a common regulatory framework and the convergence in national supervisory practices. The achievement of this key requirement for financial stability should be facilitated by the new EU regulatory arrangements – the so-called four-level "Lamfalussy-framework". The Member States and the European Commission are committed to ensure that the best mechanisms for stability and crisis management are in place in the EU, including comprehensive cooperation and exchange of information between all relevant authorities. This commitment applies not only to relations within the EU, but also to relations with our partners in multilateral or bilateral fora.

The global role of the Euro

This brings me to the different global roles that the Euro plays.

To begin with, the Euro clearly reduces the risks faced by participants in international trade and investment. It provides an anchor for countries searching to import economic stability. It also has the potential to foster cooperation among the major world economic regions. In all of these roles, the euro brings a new dimension to the way in which the system functions and is managed.

Since the introduction of the euro, 300 million consumers in the euro area use the single currency to purchase goods and services. Our international trade partners have also benefited from the creation of this major new currency area. They no longer have to deal with multiple currencies, and bear multiple currency risk, when they deal with different countries within the euro area. This is reflected in the use of the euro as invoicing and settlement currency. In 2002, in most euro area countries, the share of the euro denominated exports was between 50% and 60% for both goods and services.

For some countries outside the EU, the trade share denominated in euro even exceeded the size of the bilateral trade share with the EU, suggesting that the euro is also used for the invoicing of trade between third countries.

With the recent sharp rise in oil prices, especially in dollar terms, the issue has been raised whether we would benefit from a switch to invoicing oil in euro instead of the US dollar. Although increased invoicing and other use of the euro in international trade clearly yields potential benefits for the euro area economy -- such as seigniorage, easier access to external financing and reduced price volatility for imports – the Community does not actively promote the international use of the euro as an independent policy. The continued implementation of stability-oriented macroeconomic policies and further progress with financial integration within the euro area, however, are expected to underpin also the attractiveness of the euro as an international currency.

As we have seen, the integration of financial markets within the euro area has progressed swiftly. Deeper and more liquid markets for euro assets are of obvious interest for foreign investors. The euro has, thus, quickly established a strong role as an investment currency and store of value. It allows foreign investors – both private and public – to diversify their portfolios. As a currency for the issuance of international debt securities, the euro lies slightly ahead of the dollar. Its share in official foreign exchange reserves, again at roughly one fifth, exceeds positions held by euro precursor currencies. Diversification into the euro reduces the risk for investors who were exposed to dollar assets and the dollar exchange rate.

So far, I have talked about the possibilities that the use of the euro provides to individual economic actors to reduce their exposure. But has the introduction of the euro also reduced exchange rate volatility at the aggregate level? There are three aspects to this question.

- First, as far as the euro area is concerned, the answer is trivial. As there are no internal exchange rates any more, there can be no intra euro area exchange rate volatility. Almost six years into EMU, this has become quite natural to us. Also, the ten new Member States are expected over time to adopt the euro when the right conditions are in place and the necessary requirements are met. Participation in ERM II is a first step in this direction. In this respect, it is notable that three new EU countries (namely, Estonia, Lithuania and Slovenia) joined this exchange rate mechanism last June.

- Second, there are currently some 50 countries with an exchange rate regime linked to the euro. Its stability-oriented and credible monetary framework makes the euro an attractive anchor currency, which, in turn, allows the pegging countries to import some of this stability. Calling the euro a stabilising pole in the international monetary system is therefore by no means exaggerated. The pegging countries outside the EU are mainly in the EU's neighbourhood or linked to the euro through special institutional arrangements, like the CFA zone in Africa. This regional dimension in fact reflects trade and financial links and allows the pegging countries to minimise currency mismatch.

- The third aspect of overall exchange rate volatility covers the relations among the major international currencies. There has been much speculation about how the introduction of the euro would affect the exchange rate volatility among the three big economic entities. Economists do not agree on the basis of theory whether a "tri-polar" monetary world involving the US Dollar, the euro and the Yen would mean more stability or less. So, the issue has become an empirical one. It is still too early to draw final conclusions on this matter, but the experience of the first years of the euro was that exchange rate volatility has not dramatically changed in either direction.

This leads me to a few remarks on international cooperation that aims at preventing crises and handling them effectively when they occur.

The challenges to financial stability have greatly increased over the past two decades. Globalisation has triggered an enormous increase in trade and capital flows, which is hugely beneficial for development worldwide. However, opening up to financial flows has also increased the vulnerability of countries to a reversal of such flows, and deeper international integration has favoured the propagation of shocks and contagion.

Therefore, the European Community supports the ongoing efforts on the multilateral level to enhance the resilience of the international financial system and to improve the prevention and orderly resolution of crisis. In particular, the Community puts its weight behind five priorities:

- First, more transparency and better policy making procedures in both the public and private sector;
- Second, an improved financial sector framework, including established international codes and standards, an adequate institutional setting and financial infrastructure, a sound legal environment, and robust payment systems;
- Third, private sector involvement in the resolution of financial crisis in order to reduce moral hazard and limit the burden on the public sector;
- Fourth, an orderly and properly sequenced liberalisation of capital flows in the emerging economies. Domestic financial systems, including supervisory capacity, must be sufficiently developed before they are fully exposed to the international financial market. In this context, the Community also supports properly targeted and high-quality financial and technical assistance to developing countries.
- Fifth, improving the external representation of the euro area. The weight of the Community in the relevant international fora, in particular the G-7, the Bretton Woods Institutions and the Financial Stability Forum, depends on its ability to speak effectively with one voice. So far, the euro area dimension has been reflected through rather limited pragmatic changes, such as the attendance of the Eurogroup President and the ECB President to the part of the G7 Finance meetings related to the global

economic outlook. There has been some progress, though. Take the coordination of EU positions at the IMF. EU Member States elaborate together the position the Presidency takes in the International Monetary and Financial Committee and often adhere to a common line with respect to key international economic policy issues and developments in the major economies. More recently, we have decided to appoint a president for the Eurogroup for a two year period. These are steps in the right direction but we need to make further progress on the euro area' external representation.

A proper representation of the euro area in international organisations could significantly improve multilateral co-operation. The challenge related to the appropriate representation of the euro area and its appropriate participation in international decision making procedures is thus a significant issue for non-Europeans as well. An appropriate representation will allow the euro area to play an international role commensurate to its financial and economic weight. It will also provide the other major international actors with a real partner for dialogue and international co-operation. This would probably build the basis for further improving international financial stability.

In sum, the euro has proven a strong catalyst for the strengthening of the EU financial system. Much remains to be done, before we can reap the full benefits of a truly pan-European financial market and fully establish the euro as an anchor of stability in the international monetary and financial system.

However, it is clear that we have already gone a long way towards achieving these objectives.

Thank you for attention.

Before turning to the next speaker (Mr Richard Portes), I would now like to open up the floor from a brief “question-and-answers” session.

Who would like to begin?