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EMU: Experiences to Date and Challenges for the Future

Have the first two years of European Monetary Union fulfilled the expectations of its supporters? Or have the fears of the critics been confirmed? What challenges will EMU have to face in the years ahead?

Willem F. Duisenberg*

Europe's Contribution to the Stability of Financial Markets

The European Union (EU) plays an important role in global financial markets, for two main reasons. First, its size in the global economy is roughly similar to that of the United States. Second, the financial markets of the EU are liberalised and therefore open to global investors and borrowers.

The process of Economic and Monetary Union (EMU) in Europe influences the stability of financial markets in several ways. On the one hand, EMU brings sizeable benefits related to a more efficient allocation of financial resources amongst borrowers and investors, both within the euro area and beyond. On the other hand, there are financial stability issues associated with deeper financial market integration. These issues arise mainly from the possibility of a wider and more rapid propagation of shocks across a highly integrated area.

In my remarks, I should like to examine the implications of EMU, including – in particular – the introduction of the euro, for financial stability in the euro area and at the global level.

Efficiency Benefits from EMU

Available evidence indicates that the benefits the efficiency of the financial markets reaps from EMU have five main sources.

First, since the Maastricht Treaty assigned to the ECB the primary objective of maintaining price stability, in the years preceding the introduction of the

euro, inflation expectations in the euro area progressively declined to levels in line with price stability. A monetary policy firmly pursuing the objective of price stability contributes to a stable macroeconomic environment, which is, in turn, conducive to the stability of financial markets. In particular, a clear anchor for inflation expectations contributes to the efficiency of the price formation mechanism in the financial markets. Monetary policy can also contribute to financial stability by reducing, to the extent possible, the occurrence of surprises related to monetary policy decisions, thus avoiding any unnecessary volatility in long-term interest rates. Conversely, the conduct of monetary policy is greatly facilitated in an environment of financial stability.

Second, in the context of EMU, the governments of the EU Member States committed themselves to establishing and maintaining sound public finances. Sound public finances contribute to economic stability and thereby to the stability of financial markets. In general, the best contribution that economic policies can make to the stability of financial markets is to retain a stability orientation and to be conducted prudently and in a forward-looking manner. This should make it possible to avoid the sanctions of abrupt adjustments which market forces can impose on unsound or erratic policies. In addition, the process of reducing government deficits and debt has created some room for private borrowers in the markets for debt securities, thereby contributing to the development of the private capital markets in the euro area.

Third, following the introduction of the euro, the private capital markets of the euro area have also benefited from the abolition of intra-area currency

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risks and from the removal of a number of constraints which used to be imposed on institutional and other investors. The development of strong private capital markets can alleviate the problems of access to credit which may arise from banking problems. At the same time, banks continue to play a key role in the European financial system, on account of their activities in underwriting and asset management, for instance. They constitute the main source of liquidity for other financial and non-financial firms in times of financial market stress. Strong banking systems can help to overcome a standstill in capital markets, such as that which occurred during the episode of financial market turbulence in the autumn of 1998.

Fourth, with EMU, financial markets have become more integrated within the euro area. They have become more open towards non-resident borrowers and investors. The integration of financial markets, both within the euro area and at the global level, increases the range of borrowing and investment possibilities available to economic agents, thus contributing to the allocation of savings to the most productive investments. In addition, the removal of obstacles to the integration of financial markets can contribute to the spreading of technological advances and financial innovation. More generally, it can enhance financial performance, both within the euro area and at the global level. Although great progress has been made in the integration of financial markets within the euro area, the process of integration is not yet complete, in particular with respect to retail banking, for instance.

Fifth, with inflation expectations stabilising at low levels, the inflation risk premium has become relatively less important as a determinant of financial prices within the euro area. This creates room for other factors such as credit risk to play a more important role in the price formation mechanism. This contributes to what I have once called the development of a "credit risk culture" in the euro area, which helps investors to focus more on the underlying soundness of borrowers.

The establishment of a clear anchor for inflation expectations, the integration of financial markets and the development of capital markets for private borrowers all have benefits in terms of the efficiency of financial markets. This would tend to reduce the likelihood of abrupt adjustments in financial portfolios and financial prices which, in less well-functioning financial markets, correct inefficient financial resource allocations from time to time. More efficient financial

markets should be less conducive to the development of bubbles, whereby financial prices diverge from the values implied by fundamental determinants for prolonged periods of time.

Special Issues for Financial Market Stability

Despite their benefits, the structural changes under way in the euro area also highlight some special issues for financial stability.

A first issue relates to the fact that progress in integration leads to changes in the nature of risks faced by borrowers, investors and financial intermediaries. In particular, the expansion in cross-border transactions between financial intermediaries can lead to an increase in the exposure of financial intermediaries to developments occurring in other countries of the euro area. The increase in financial transactions going beyond national boundaries within the euro area is a development which is welcome, since it provides an opportunity for a better diversification of the risks faced by financial intermediaries. However, at least in the initial stages of the existence of the euro, financial transactions going beyond national boundaries within the euro area may be affected by sizeable information asymmetry and information verification problems. This could complicate the assessment of risks inherent in these transactions. As a result, some financial intermediaries may fail to establish and maintain adequate cushions in order to cover the risks incurred in cross-border transactions. In the presence of such excessive risk-taking on the part of financial intermediaries, there is a possibility that problems faced by financial intermediaries in one region of the euro area could spread rapidly to financial intermediaries located in other regions of the euro area. In such circumstances, there could be an increase in financial market volatility at an area-wide level as well as in the frequency of occurrences of financial distress at the company level. This could hamper the mechanism of allocation of financial resources and impose large costs on the economy.

Obviously, a remedy to the occurrence of such problems is the maintenance of adequate capital cushions by financial intermediaries, which enable them to cover potential losses. Prudential supervision has an important role to play in ensuring that financial intermediaries comply with capital adequacy requirements and maintain sound internal risk management practices, particularly when their businesses evolve in relation to the changes occurring in EMU. In this regard, a peculiarity of EMU is that prudential super-

vision is under the responsibility of national authorities. Its field of jurisdiction is therefore not the same as that of monetary policy, which is exercised at the level of the euro area. Under the so-called "home country" principle, each financial institution in the European Union is unequivocally under the jurisdiction of a single national supervisor. This framework for prudential supervision has the advantage that it imposes a light regulatory burden on financial institutions and facilitates access to local information.

However, while the existing institutional arrangements can provide an adequate and flexible basis for safeguarding financial stability, we need to strengthen co-operation and the exchange of information between supervisors and central banks in Europe. This was also seen as vital in the recent report on financial stability prepared by the Economic and Financial Committee.¹ If problems at a major financial institution were to have effects in other countries, information should be effectively distributed and common solutions should be sought when needed. As for the regulatory regime, one current drawback is that the adaptation of regulatory requirements, which is necessitated from time to time, can be a lengthy process requiring amendments to Community legislation.

A general remedy to the problem of potentially excessive risk-taking by financial institutions is the improvement of disclosure practices, whereby financial institutions inform the public about their risk profiles. Disclosure reduces information asymmetries between financial institutions, on the one hand, and borrowers and investors, on the other. As clients of financial institutions become better informed about the risk profiles of financial institutions, they are better able to compare the prices of services offered by various financial institutions, thereby allowing the forces of competition to discriminate against financial institutions with excessive risk exposures relative to their capital cushions.

A second issue for financial stability arises from the fact that, in the course of the process of structural change under way in the financial markets of the euro area, new infrastructures are being developed, such as new payment systems or new trading systems. These new infrastructures often use more advanced telecommunications and computing systems than their predecessors and bring together a larger number of market participants. This permits the achievement of more rapid and secure processes as well as lower transaction costs. In addition, some of the new infrastructures permit a concentration of activity on single

harmonised platforms instead of fragmented ones. This can also contribute to a reduction in total costs. However, the new infrastructures need to be able to withstand conditions of high financial market volatility or high trading activity, as well as the failure of some market participants to fulfil their obligations. Appropriate mechanisms need to be in place to ensure a smooth functioning under such conditions, in order to avoid the risk of gridlock, which could be damaging for financial markets. Such a risk would be particularly acute when infrastructures have become very concentrated, as the consequences of failure would affect a large number of users. It is therefore important that safety standards are rigorously applied in the newly developed infrastructures for euro area financial markets. As regards payment and settlement systems in particular, in accordance with its tasks assigned by the Maastricht Treaty the ECB seeks to promote the setting up of safe, sound and efficient payment and settlement systems, for both wholesale and retail payments, including electronic money.²

Conclusion

Evidence available thus far suggests that the benefits brought by EMU and, in particular, the introduction of the euro to the stability of financial markets are sizeable. They concern both the residents of the euro area and the rest of the world. These benefits derive mainly from the establishment of a clear anchor for inflation expectations, the integration of financial markets and the development of capital markets for private borrowers. However, the integration of financial markets and the development of capital markets for private borrowers should be seen as ongoing processes. In some areas, such as retail banking, financial markets in the euro area are still segmented. In addition, the process of structural change which is currently under way in Europe highlights some special issues for financial stability. Both prudential supervision and payment and settlement system oversight have key roles to play in this regard. If the challenges posed by the process of structural change in European financial markets are appropriately addressed, and if economic policies are pursued with a stability orientation, prudently and in a forward-looking manner, I am confident that Europe's contribution to the stability of financial markets will be very positive.

¹ Economic and Financial Committee: Report on financial stability, Economic Papers, No. 143, May 2000.

² ECB: Role of the Eurosystem in the field of payment system oversight, June 2000.