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THE IMPACT OF THE EURO ON NATIONAL FINANCIAL SYSTEMS

SURF Seminar "Impact of the euro on organised financial markets and, specially, on derivative markets", hosted by MEFF Renta Fija.. Barcelona

As part of the SUERF Council of Management meeting, sponsored by MEFF Renta Fija, the Spanish financial futures market, a small seminar has been organised on the impact of the euro on financial markets and, especially, on derivatives markets. Discussion will turn on two papers: one by Robert McCauley of the BIS, addressing the impact of the euro on public debt markets; and another by Enrique Vidal Ribas of MEFF, tackling more specifically the effect on derivatives markets.

It was thought best that these specific topics should be part of an overall perspective of the impact of the euro on the financial system as a whole, which will be the subject of the next SUERF colloquium. I intend to review briefly the likely transformations from the viewpoint of the specific problems the Spanish financial system will face.

Economic and Monetary Union (EMU) is a highly ambitious political project with far-reaching economic implications. In economic terms it signifies the lifting of the last of the barriers still separating national markets, namely the presence of different currency units and potentially adjustable exchange rates.

The elimination of national currencies will step up competition and prompt a major reallocation of resources and restructuring in the productive activity of many sectors. It will also make the least efficient areas of the productive system more vulnerable.

All these changes will, no doubt, be particularly intense in the financial sector, as here the principal commodity is money, which will be subject to the most immediate change as a result of EMU.

Analysing the repercussions of the introduction of the euro on national financial systems is an extensive task. This is because ultimately all economic agents, including non-financial firms, households and general government, are in some way part of the financial system, and their practices will be affected by the change of currency. This initial approach to the subject will thus be confined to financial markets and financial institutions. An outline of these is shown in figure 1. The areas in red are those that will be specifically addressed in this session in the papers announced. In my introduction I shall refer only to the areas in blue in order to complement these papers and establish a broad framework.

Under the agreed timetable for the changeover to the euro, it is in the money markets where changes will be most immediately perceptible. With

TARGET in place, virtually instantaneous arbitrage should be possible between national money markets, making a single, integrated European money market a reality, within which the single monetary policy will be conducted. If banks can obtain funds in any EMU member state and the transfer of these funds is sufficiently swift and cheap, price differences between the various national money markets will tend to be negligible. That said, minor differences reflecting different credit risk evaluations might remain in the longer-dated segments. The major economies of scale arising in payment systems mean it will be possible to achieve efficiency gains by means of concentration, so that very powerful forces in EMU will work towards money market centralisation. If this is the case, most of the big national institutions will lose their domestic market dominance, operating instead in a global market where competition will be much fiercer. It is also highly likely that institutions currently operating simultaneously in several European money markets will tend to centralise their treasury operations in a single location. Foreseeably, the biggest money markets will be those attracting most business in this process.

Nonetheless, the different degrees of operative efficiency in the various interbank markets may also play an important role. Due to differences in efficiency, security and cost among the different national payment systems, shifts may well take place from certain national money markets to others, with the former losing weight. As a result of this competition banks will be able, in the future setting of the European Union, to count on these payment systems maintaining high standards of quality and low prices, as their administrators will seek to avoid the loss of business.

Set against the medium-term centralising forces of the European money markets will be short-term factors retarding this process. Along with the decentralised implementation of the single monetary policy, mention should be made of the importance of knowing counterparties when undertaking interbank operations. This is because significant risks are run in such operations since, in general, non-collateralised transactions are involved. Given the fragmentation of financial systems and the difficulties of knowing with accuracy the financial situation of other institutions, interbank operations in the euro market -where up to 10,000 institutions may operate- may be expected to be matched primarily between institutions located in the same national market. This does not exclude the possibility that a set of major European commercial banks will carry out the bulk of the arbitrage operations between the various national segments of the euro market, forming thereby the core of the future European integrated money market.

Broadly speaking, interbank activity will tend to shift to where it is cheapest and most efficient. Aspects such as the availability of quality collateral for repos, the flexibility and price of settlement services and the effectiveness of market makers and other intermediaries will be most important.

The tendency towards concentration will no doubt be clearly and immediately visible in the currency markets, where the major international banks will gain a dominant position. Competition will prompt a reduction of commissions and spreads, which are already low, and there could also be a fall in income from speculative trading, once the euro is in place and floating against the dollar and the yen. This adverse impact could be partly offset by an increase in trading in the euro, as it becomes one of the currencies most used in international transactions, and by the growth of business in emerging economies' currencies. Here, for instance, Spanish banks may have a comparative advantage enabling them to capture a sizable volume of business in Latin-American countries' currencies.

The debt markets share certain features with the money markets. But I shall leave this area and that of the derivatives markets since, as I stated, they will be analysed in depth in the papers to be read at this seminar.

The European markets for private bonds and equities will foreseeably surge, for different reasons. In the short term these instruments will be strongly boosted by the privatisation programmes pursued under the current fiscal consolidation and liberalisation strategies. The fact that the ESCB will accept private paper meeting certain liquidity and risk conditions as collateral in its lending operations (as will TARGET for intraday credit) may also have something of an impact. In the medium and long term this surge should be sustained by several factors: a lesser rate of public debt issues, moderate interest rates (as befits an area of price stability), an expansion of institutional investment and strong foreign demand for euro-denominated instruments.

The capital markets will generally see a heightening of competition. Moreover, a tendency towards concentration may be expected since the biggest firms' operations will tend to be transacted in the principal financial centres. Nonetheless, in most cases banks will retain strong access links to existing clients and a better position for evaluating specific risks. At the same time, a high demand for collateral will lead to an increase in the securitisation of transactions. The role national or regional markets can continue to play will depend on their competitiveness in terms of the efficiency and cost of the services they supply. Keeping commissions low and settlement systems competitive, along with facilities for connecting with other trading platforms, may continue to attract a growing number of operators to peripheral national markets and generate higher trading volumes.

So far I have referred to the impact of the euro on certain organised financial markets. However, given the importance of banks in the European financial system, it is very important to assess the impact that the foreseeable changes may have on them. It is worth distinguishing here between the different groups of institutions. In the area of wholesale banking, EMU will help to accelerate the changes taking place in recent years in Spain and other European countries. The globalisation of European financial markets and the foreseeable increase in trading volumes on private securities markets, as I mentioned earlier, are therefore likely to boost further disintermediation, so reducing the importance of credit to this sector. At the same time, large banks established in the most important markets will probably tend to gain market share in the area as a whole, prompting greater concentration.

The retail segment will, at least at first, probably be the least affected by the introduction of the euro, due to the persistence of certain barriers to the entry of external competition. It is worth highlighting here the importance that an extensive branch network and direct knowledge of customers will continue to have. Also, the maintenance of national currency denominations during phase 3A and the scarce harmonisation of the retail payment systems will, at the start of EMU, hinder rapid integration of this market segment at the European level.

All this notwithstanding, significant changes in retail business are not to be ruled out. The possible defensive strategies of retail banks will help to increase competition, as has already occurred in recent years. In turn, the introduction of the euro, by eliminating currency risk, will be conducive to greater competition between European banks in the most accessible market segments, such as certain deposit products and certain lending operations, including mortgage loans. It should not be forgotten, in this respect, that EMU will enable operations in national markets to be financed with funds raised in other member countries, so that it would not be necessary, as it is at present, to establish a branch network to raise funds in national currency in order to compete in a particular market.

Admittedly many of the retail banking changes mentioned are to a greater or lesser extent already under way. But, in a more distant future, generalised supply of retail products through new channels of distribution based on the application of new technologies and the development of rapid and efficient transnational payment systems may substantially change the business conditions of this sector. In this new context, the branch could lose importance as a distribution centre, thereby weakening the position of institutions with extensive branch networks.

In addition to the factors I have just mentioned, another of the main consequences of EMU will be the need to incur certain extraordinary expenses arising from the necessary process of adaptation of banking operations to the euro. This will, naturally, be driven by customer demand for services in euros. Yet competition is likely to force banks to offer a wide range of services in euros relatively quickly, if they wish to avoid the risk of losing market share. Moreover, decisions like switching capital market transactions to the euro and the reform of payment systems to allow fund transfers in both the national currency unit and euros will be additional factors which may lead banks to adapt rapidly to the euro, with the costs that entails.

The model for transition to the euro would seem to be rapid adaptation of all operating systems so as to offer, from the outset, a broad range of operations in both national currency and in euros. This will make necessary the modification of numerous procedures and systems, which will require a considerable effort, particularly when it comes to the adaptation of data-processing systems to the new situation. Here it is vitally important that suitable strategic plans be drawn up well in advance, in order to be favourably placed to take advantage of the business opportunities which EMU is bound to generate.

As already stated on several occasions, banks will have to further their efforts of recent years to cut operating costs, introducing systems which allow the profitability of the various product lines to be readily assessed so that those with the narrowest margins can be identified. It will also be necessary to continue rationalising branch networks, downsizing if necessary.

Strategic plans will also need to be laid to adapt to a single financial space with a physical size and number of players greatly exceeding those of the existing markets. Banks will have to define the countries and business segments in which they wish to have a presence. The need to attain the right size for the new scales of the various segments of banking business may trigger mergers and the restructuring of numerous credit institutions.

Significantly, the development of the single European market will open up great business opportunities for the institutions and markets which manage to position themselves correctly. It will therefore be possible to earn profits which more than offset the expenses and reductions in income which may result from adaptation to EMU and the disappearance of certain lines of business.

It should not be forgotten that European integration may help to boost banking business in several areas. Lower prices for financial transactions as a consequence of lower interest rates and commissions and the foreseeable increase in economic activity will help to foster growth in financial activity. There will thus be a greater volume of business to share among the various financial intermediaries. Furthermore, greater price stability will foreseeably increase household saving, thus offering financial intermediaries new business opportunities which will more than offset the costs of adaptation to the euro. The banks to benefit most will be those which demonstrate the greatest capacity to adapt to the new conditions. Spanish financial institutions can be expected to be among those which manage to exploit the new business opportunities offered by a single financial market. If they are to do so, however, they must make the inevitable preparations and seek to adapt with diligence and in good time.