EFFECTS OF THE EURO ON THE BANKING AND CAPITAL MARKETS

Gazi Erçel
Governor
The Central Bank of The Republic of Turkey

Dünya Gazetesi, Euro Meeting
İstanbul
November 27, 1998

Very soon, on January 1, 1999, we will enter the third stage of the Economic and Monetary Union in Europe. At that time, the 11 founding members of the European Monetary Union will launch the Euro as their common currency. Monetary and exchange rate policies will no longer be independently determined by these countries, but will be decided jointly with the European Central Bank. And while these countries will still conduct their own budgetary and labor market policies, the Stability and Growth Pact and the rules of the Maastricht Treaty will be observed.

So, a new world force will officially enter into full existence at the turn of the next year. The developments which will make the Euro the second most important currency in the world will affect sectors, countries, and whole regions. These effects will be strongest in the Euro area, as well as in the countries and sectors most closely connected with the Euro area.

In my presentation today, I wish especially to describe the predictable effects of the Euro on banking and capital markets. It is natural that the industrial sector will be the most strongly affected by the introduction of the Euro; and there is no doubt that the industrial sector has the most to gain from a more efficient banking sector and deeper capital markets.

Meanwhile, let me also say that I do not think there will be any change in the timetable for the introduction of the Euro into the markets. The authorities from the Euro governments and the governors of the Euro central banks see eye to eye on this matter. In recent months, speculations about how the Euro timetable would be affected, if the global crisis should deepen, were replaced by debates about how quickly demand for the Euro would increase and what direction the monetary policy of the European Central Bank would take. In addition, it is generally agreed that such a historically rare occurrence cannot be evaluated or measured by its short-term effects. The introduction of the Euro is one of the greatest events of our age, with consequences comparable in their magnitude and duration with the Marshal Plan or the Bretton Woods Agreement.

Let me briefly describe how the Euro will make itself felt in the international arena, before moving on to its effects on banking and the capital markets.

I believe the Euro will have **four important consequences for the international markets**.

First, the Euro will enter the international monetary system as an **exchange rate**. The US dollar, the Japanese yen and the Euro will make up a tripartite monetary system.

Second, **the strength of the European Central Bank's credibility** will be linked to the value of the Euro. The credibility of the European Central Bank will increase only if the Euro fluctuates little, makes Europe's economy more stable, and exhibits little interest rate volatility.

Third, the Euro will soon become an **"anchor" currency**. Many countries that do not belong to the European Monetary System will peg their currencies to the Euro and conduct their exchange rate policy accordingly.

And fourth, the Euro will become a reserve currency in which **international reserves** can be held.

Once the Euro has been introduced into the system as a strong currency, the effects it will have on the banking sector can be described under seven headings.

First, **the liberalization** of the banking system will gradually accelerate after the advent of the Euro. In this new liberalized banking environment, it is not be wrong to suppose that inflows into the system will increase, and that this increase, in turn, will promote competitiveness. However, liberalization will also require closer adherence to the rules of the market. If the banking sector is healthy and acts in accordance with the rules, then it will also become the guarantor of financial stability. Such a banking system will ensure the harmonization of banks' activities, and their clients will doubtless find advantage in the changes.

The second effect will take the form of a **process of internationalization**. The banking system, by virtue of its global vision, will integrate itself more easily into the European Monetary System, and by providing all kinds of financial services, will find its place in the international scheme of things. The international monetary system based on a triple exchange rate will give those banks whose size, strategies and instruments are appropriate in the global environment a higher place on the ladder. Otherwise, the number of local banks would increase, and the small banks would operate locally.

The third effect of increasing use of the Euro in the system will be to bring about efficient, widespread use of **information technology** in the banking system. Banks that lack the infrastructure needed to support the information technology will no longer be able to take deposits, extend credits, provide their clients with advanced banking services, or to carry out such services cheaply. In many European countries there exist some banks that have fallen behind in the information age. Their chances of surviving in a competitive environment will be infinitesimal if they cannot satisfy the requirements of the information age.

The fourth effect will involve **the management and strategies** of banks. It will not be possible to stay one step ahead in this banking system with its strong competitiveness and technological infrastructure without highly qualified managers using efficient methods of management. Banks will be profitable only if they employ capable, experienced, well-informed managers who are accustomed to working in a competitive environment. In addition, bank managers will have to keep current with rapidly growing and changing principles, theories, and applications of management.

The fifth effect, **securitization**, will make itself strongly felt in the banking sector. Not only the growing share of securities in the assets of banks, but also competition between deposit holders and institutional investors, or their tendency to act in the same direction, will affect banks' liabilities. At present, deposit holders and institutional investors no longer behave in the same ways as they did in the 1970s, the 1980s, or even the 1990s. In an environment characterized by large flows of information and fierce competition, movements are rapid and can change direction easily. At present it is hard to predict just where their investment strategies will be directed once the Euro has been introduced, but it is safe to say that the effects of that event will be felt from now on.

Securitization, which will help large firms raise money by issuing more securities, will also lead to a situation where small- and medium-sized firms dominate the assets of banks. This, in turn, will show how the banks can live together with small and medium-sized firms as well as with individual borrowers. It is an important characteristic of Europe that small- and medium-sized firms have a dominant place in their economies.

The Euro's sixth effect has to do with **banking supervision**, which must become stronger more extensive, and conducted in such a manner as to prevent problems. In fact, many countries have begun to implement the "25 Core Principles in Banking Supervision" promulgated by the Bank for International Settlements last year. Because the banking system lies at the root of financial crises, bank supervision should give first priority to preventive measures and the preservation of financial stability. Banking supervision will experience many more changes after the year 2000 than ever before. And banks in countries that keep up with these changes will have the upper hand in the international system.

Seventh and last, increased competition and changing world conditions have also brought about an increase in **bank marriages**. In the European Monetary System which will be formed on the launching of the Euro, it is inevitable that take-overs and mergers will be accomplished in order to create firms that are stronger and more profitable. We have already seen many examples of this, and I think this trend will continue and increase.

The effects of the Euro **on the capital markets and portfolio management** will vary in magnitude and direction. The behavior of portfolio managers will be particularly affected by the elimination of domestic exchange rate differentials and international interest rate differentials, and by the transformation of 11 domestic markets into one single market. Portfolio managers are expected to head towards new markets or currencies outside the Euro area, rather than the European capital markets which used to be of great interest in the past to fixed-income investors because they have offered such a wide range of investment alternatives, based on interest rate and exchange rate differentials. The markets and currencies in countries that are not part of the European Monetary System, and those in countries that are still candidates, may satisfy these investors to some extent.

Furthermore, I believe that public sector borrowings will play an even smaller role than now in the European capital markets of the near future. It is expected that these countries will keep a low profile in the markets because of the ever decreasing budget deficits in the countries of the European Union.

The reduced budget deficits, and the participation of other countries in this trend, are increasing expectations that worldwide interest rates, which are already low, will come down further. Such a development would reduce the demand for fixed-interest instruments.

Another development expected in the Euro capital market is that the investment capacity of the insurance sector will be built up, following arrangements made in this sector. Funds coming from powerful insurance companies that have the quality of institutional investors will make a large contribution to the expansion of the Euro capital market.

In light of these developments, at present it does not seem easy to predict how the yield curve of the Euro will evolve. One thing is certain: the Euro yield curve will have a global character. I do not think it is mistaken to assume that institutions belonging to each country will have a specific place somewhere on this curve. The concentration of certain countries around particular maturity dates will determine the course of the curve.

Having generally summarized the effects of the Euro on the banking and capital markets, I think we should think about how Turkey can take advantage of these developments. As I have already mentioned, we must understand and analyze the markets and predict developments, even if sometimes imperfectly, if we are to make use of the competitive, efficient, large and globalized markets of the future. Once we have done our homework, the benefits to be obtained will depend on the strategies and applications followed by individuals, institutions, and governments.

The opportunities, choices, and advantages which will be available to us in such a large and efficient market, will go hand in hand with our approach to the subject matter and the measures we take. For this reason, only banks, capital markets, institutions and governments that prepare themselves well during this transition period will be able to obtain the maximum benefits.