Frankfurt E B C

Europe Convening

12th Frankfurt European Banking Congress · 2002

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Europe Convening

Petra Roth

Ladies and Gentlemen,

It is a great honour and pleasure for me to welcome you to our city for the twelfth Frankfurt European Banking Congress.

When the banking community and the city of Frankfurt initiated this conference in 1991, we did not expect that this event would be such a long-term success. Thank you very much for attending this congress.

Frankfurt, as a leading European metropolis, is proud to host this conference for the 12th time. The current economic situation in Germany and Europe is serious, but, and I need not tell you, in Germany it is especially so, as Germany has become known as the "tail light" of Europe. The present German data available do not reflect some positive aspects of Frankfurt's economy, for instance the unemployment rate, which thankfully remains under 6%. Within the last 24 months, however, Frankfurt's tax revenues have decreased by an unacceptable 38%. As the Lord Mayor of this city, I assure you that the city's Council and Parliament will get their financial house in order, and, at the same time, in spite of these sombre times, Frankfurt will remain committed to fulfilling its objectives. For example, Frankfurt will continue to invest in its highly-developed infrastructure so that it can become even a more attractive venue for the financial and business community.

As Lord Mayor of Frankfurt, with a chair on the Committee of Regions in Brussels, I will resolutely follow the path of increasing Frankfurt's significance as a major metropolis on the European scene. For many of the issues now facing the European Union as a whole, from agricultural and federal policies to labour mobility, Frankfurt's influence and perspective can provide positive answers and solutions.

With great enthusiasm and optimism, I envisage great achievements for the future of Europe; it will be a Europe for the people and run by the people; a constitutional Europe with one day perhaps even its own president.

It is easy to see why Frankfurt, with its cosmopolitan character, forward-looking city-planning, vibrant financial and business community, splendid infrastructure and central European location is a top metropolis, worthy of praise.

The markets of the financial world are experiencing dramatic developments. What seemed to be right only three or four years ago now appears to be wrong. Above all, it has been proved that the financial markets cannot distance themselves too far from the development of the gross national product. This is especially true for price quotations on the stock exchange. Now we are witnessing profound measures of adjustment which have brought the banks and other financial service industries to the attention of the public. But I'm hopeful that the financial sector will emerge stronger than before from this crisis.

And because financial business is a key sector of Frankfurt's economy, I am confident we will experience once again a stronger commitment of the players – big ones as well as small ones – to the Frankfurt financial marketplace.

This congress is a good example for the motto “Think global and act local“!

With the launch of European Monetary Union, not only the landscape of the financial markets has changed. It has also become clear that the gap left open in the treaty of Maastricht between political and economic integration must be closed as soon as possible. Jean Monnet himself predicted that a European monetary union would lead to a political union as well. And with a view to the enlargement of the union, which also means new candidates for European Monetary Union, this appears urgently necessary.

Seeing the current economic crisis, I think we are in danger of overemphasizing the problems of European integration a little. Far too often we forget what a historically unique project we Europeans have launched together: to build up a social and federal Europe, a Europe which speaks with one voice and which is economically and politically strong enough in the concert of superpowers of today and tomorrow. It is quite certain that there is still a long way ahead. But despite all the difficulties we see today – such as questions of agriculture and structural aid or labour mobility – and which may still arise during this process of integration, we should keep in mind the strategic goal of a true European Union. And if with the next steps of integration we can achieve more direct democracy and less bureaucracy in European decision-making processes, we will have a good chance of achieving this goal.

I would now like to express my gratitude to the steering committee of this congress as well as those who have made this congress possible. Especially, I would like to thank Klaus-Peter Müller, chairman of this year's congress, and the panellists, all of you distinguished figures from business and politics, for sharing your views and expertise with the audience.

To all of you I wish a successful congress and a pleasant stay in Frankfurt am Main.

Europe Convening

Klaus-Peter Müller

Madam Lord Mayor,
Thank you for your opening statement.

Dear President Prodi, ministers, govenors, excellencies, ladies and gentlemen, I should also like to bid you a warm welcome in Frankfurt.

At the same time, I want to welcome the representatives of the media, who – I am sure – will once again give this congress the coverage it deserves. It has now become a tradition and never fails to provide interesting insights.

One feature of this year's congress is rather different, however. We have competition in the form of two events which are taking place elsewhere. One of them is the meeting of the finance ministers and central-bank governors of the G20 countries in New Delhi. So we are pleased that, despite this, three central-bank governors have joined us today. The other meeting is in Prague where the eastern enlargement of Nato is being celebrated.

Once again, this congress has very distinguished experts and a promising programme. And it seems to have struck a chord with you, our audience, bringing such a large number of you to us in the Alte Oper here in Frankfurt. I cannot mention all the many prominent speakers we've assembled, but let me just point out that we will have the opportunity to listen to a keynote speech by the president of the Federal Republic of Germany, Johannes Rau, scheduled to take place immediately before Panel II.

Incidentally, the absence of such central bankers as Wim Duisenberg and Ernst Welteke, whose final remarks impressed us so much last year, means that I will be taking over this function as chairman of today's congress.

I am very pleased to see that the executive boards of the European Central Bank and the Bundesbank are so well represented. Both central banks help us organize this congress, which is now in its twelfth year. I want to thank them for their continuing support.

However, I think this EBC differs from those in the past for another reason: as the hosts in Frankfurt, we feel under some pressure to explain the situation of our financial industry to our guests from other countries. As Petra Roth has indicated, people are asking what is the matter with Germany and its financial industry.

The reason for this is clear. Never in the past five decades or so has there been so much negative news about German banks. In the past, they used to be beyond reproach and counted as absolutely solid. What has happened?

■ Slow growth in the German economy close to stagnation for years and the dramatic fall of equity prices on a previously unimaginable scale and duration have caused banks' earnings to shrink at an unexpected pace. This has made it impossible for them to keep abreast of developments and compensate by means of cost-cutting.

■ The combination of these adverse factors triggered sharp falls in market values and further rating downgrades for German banks.

However, banks have adopted the appropriate serious stance in facing up to this situation. Unfortunately, facts and arguments are all too often neglected which, with more careful analysis, indicate that banks have recognized the need for reforms and changes, and they are acting accordingly – they are restructuring and rigorously cutting costs and are refocusing their strategies.

Let me stress – and I do hope our Japanese friends will understand the spirit in which I make this comment – it is absurd to compare the situation of the German economy or German banks with that in Japan. Germany does not have deflation; nor is it facing deflation. The main threat is a policy of ever higher taxes in times of economic weakness. Nevertheless, there is a profound uneasiness about banks in the markets. This is partly due to political developments with regard to the banking industry. After all, banks in particular react like sensitive seismographs to political disturbances and uncertainties.

■ The terrorist threat and the danger of open hostilities in the Middle East are prompting investors worldwide to demand higher risk premiums.

■ And economic policy, particularly here in Germany, isn't sending the urgently needed positive signals. Instead of Germany's very obvious structural problems being tackled and public spending being cut, we are unfortunately faced with plans to raise taxes and social-security contributions.

Against this background, our business environment remains extremely difficult. But just as every bank now has to address its problems and solve them, politicians have to ensure that the overall environment for Europe, the euro and our financial markets is conducive to growth and prosperity.

This leads us to the international role of the euro as a leading investment and reserve currency.

Panel III, which is chaired by Bernd Fahrholz, promises to be very challenging. We have representatives from the central banks of the three leading currencies and also a representative from one of the most dynamic economies globally, with large foreign-currency reserves.

President Rau and immediately after him Panel II will deal with the topic of "Constituting Europe" – in other words, the ever more urgent question of how a truly united, enlarged and deeper Europe can be created in legal and economic terms, but also in the hearts of its people.

Last but not least, Panel I chaired by Josef Ackermann, which will begin in a few moments, shows that in addition to European integration and achieving political union, the European Union has important issues to tackle. It needs an efficient structure, regulation and supervision of the securities markets, which are still far removed from being a true single market. If these don't exist, we cannot claim that "Exchanges take stock". It only remains for me now to wish you a stimulating discussion and to hand over to Josef Ackermann.

Exchanges Take Stock

Josef Ackermann

Dear Panelists,

Ladies and Gentlemen,

First of all let me take the opportunity to welcome you to the first panel discussion today.
Our topic "Exchanges take stock" – or, in other words, taking a look at the status quo and drawing conclusions – is becoming more and more important – for investors, clients and business partners. Why that?

1. Over the last 5 to 10 years, the large European exchanges have undergone a major change of character. They have successfully transformed from traditional exchange clubs to profit-focussed service providers with international approach and are often exchange-listed themselves (e.g. impressive market capitalizations of Deutsche Börse or Euronext).
2. The various, newly created electronic securities markets (Electronic Crossing Networks = ECNs) have not been able to catch on, despite all of the initial praise. The situation may be slightly different in the US, but in Europe, incumbents have been able to copy new ECN advantages at any time, which – of course – makes it extremely difficult for newcomers to attract a critical mass of liquidity from other platforms.
3. Attempts to interlock the national exchanges and financial markets in Europe and make them more efficient turned out to be more difficult than expected. Until now, no fully integrated European – let alone global - stock exchange – be it as a result of a merger or on a stand-alone basis – can be observed.

In taking a look at the future, a whole range of questions comes to the forefront, which we may want to touch upon today:
1. Now that stock exchanges, as an institution, have changed their paradigm, their objective is clear: increase companies' value in the interests of shareholders. But what are the most important levers for success in a highly competitive – and currently difficult – market environment? Where are the growth opportunities for exchanges?

2. The “ECN threat“ was hardly dispelled and another trend appears. Internalizing banks would like to handle and execute their order streams internally, forwarding only the peak of the order flows to the stock exchange. How will the exchanges react to this trend? How can it be handled in a meaningful way and to the benefit of the client / owner?
3. By going public, the exchanges have gained entrepreneurial independence. How can they take advantage of this scope to lend a new dynamic to the ongoing establishment of one European capital market? What can and what must legislators, regulators and supervisory authorities do to improve the integration of the European capital market? And: do we still need national financial centers across Europe once we have achieved an integrated capital market.

As you can see, there are a number of interesting issues on the agenda. I am delighted that the most experienced professionals in this area have accepted our invitation to share their thoughts with us today. In that regard, let me briefly introduce you to them, before we continue with the first opening statement:

– *Baron Alexandre Lamfalussy*
from the Université catholique de Louvain. Baron Lamfalussy is widely known as the Chairman of the Committee of Wise Men. In this capacity, he has contributed highly to understanding the urgency of improving the regulatory framework to enable the EU securities markets to cope with market developments. His career encompassed being a member of the Board of Banque Bruxelles Lambert, General Director of the Bank for International Settlements in Basel and President of the European Monetary Institute until 1997.

– *Dr. Werner G. Seifert*
has been the Chairman of the Board of Management of Deutsche Börse AG since 1993. Cornerstones of his career include being a McKinsey partner and a member of Swiss Re's Senior Management Board.

– *Dr. Olivier Lefebvre*
is now a member of the Management Board of Euronext in charge of legal and IT integration. His professional career began at the research department of the Generale Bank (now Fortis). He then joined the team of advisers to the Belgian Minister of Finance. Since 1996 he has served on the board of the Brussel Stock Exchange.

– *Hardwick Simmons*
is our man for the outside-in view. He has been the Chairman and Chief Executive Officer of Nasdaq since last year. He previously held senior positions with Prudential Securities and has extensive experience in the investment and brokerage business. To open today’s discussion, may I now ask you, Baron Lamfalussy, for your initial remarks.

Exchanges Take Stock

Werner G. Seifert

Dear Chairman, Distinguished Co-panelists,
Ladies and Gentlemen,

I'd like to answer three questions within the next few minutes: Why did Deutsche Börse go public 22 months ago? What are the lessons learnt since? And, how will Deutsche Börse continue to improve the performance of its stock?

1. Why did Deutsche Börse go public 22 months ago?

In the European exchange landscape, competitive moves in the late 1990s can be characterized by a large amount of political influence, but a lack of common rules of the game. Since the early nineties all major European exchanges have demutualized to become private companies. Several alliances, like Norex, Euro NM and the European Equity Alliance were created. Due to the lack of operational integration the effect of their joint efforts was limited. Most cooperation models aimed at local exchanges remaining independent. Even mergers left substantial power with all parties involved; the model of 50 : 50 governance has been a prominent result of the overly political character of these moves.

Things came to a head with iX, the proposed merger of London Stock Exchange, Deutsche Börse, Milan and Madrid, involving Nasdaq for the further development of the growth markets. This would have combined roughly 70 percent of the European cash markets on one platform, with huge benefits for investors, issuers, intermediaries and not least, the exchanges themselves. Ultimately it failed because the City was not prepared to integrate itself into a truly European framework. This was the turning point. A second phase of industrial consolidation began. With the turn of the millennium, common rules began to emerge, and the framework of a new, efficient industry structure has become visible. Only weeks after the failure of iX, Deutsche Börse went public on February 5, 2001, thus rewriting the rules for further consolidation. Euronext and the LSE followed suit in July 2001.

Now the capital market sets the rules of the game. What did Deutsche Börse have in mind with its IPO?

- First, we wanted to entice our peers to follow suit, thus increasing their shareholder value orientation too, thus unleashing a competition of business models and thus creating new incentives for consolidation
- Secondly, we wanted to receive an efficient market's neutral feedback on the validity and attractiveness of our business model. We wanted to find out if the majority of analysts/ investors were in favor of Deutsche Börse's integrated business model, against all "political" criticism. We also hoped for an efficient market to put a "more than-the-sum-of-the-parts" valuation on our existing business as well as on each strategic transaction, thereby removing room for "political" debates in M&A situations.
- Third, we wanted to enhance our financial flexibility: Our ability to finance further expansion from cash flow would not have been sufficient to cover the investment needs of the option portfolio we had in front of us. With our listing we were looking for an acquisition currency, for the possibility to increase our equity when needed, and to issue convertibles and certain fixed income products, once we would be sufficiently known in the investment community
- Fourth, we wanted to reconcile our ownership structure with our strategic objectives: Our IPO was also a "declaration of independence" from local users' interests. It was intended to remove conflicts of interest caused by the identity of "users/competitors" and "owners". We wanted to be owned by institutions with a "return-on-investment" focus, adding degrees of freedom in managing a high growth business. Also, we wanted to create an opportunity for our old shareholders to cash in and spend the proceeds for other purposes. And we wanted to strengthen our customer base through an additional interface with the European and international investment community.
- Fifth and finally, we wanted to increase the effectiveness of our governance as well as our attractiveness as an employer, e.g. by providing a stock option plan.

2. Lessons learnt: Taking stock after roughly two years

The capital market seems to like the business model of Deutsche Börse , maybe because it is so plain and simple. It's all about combining economies of scale and scope. We have engineered a high performance business model covering the entire value chain from the front office of our customers right through to their back offices, enabling us to undercut competitors´prices. We concentrate on three things: we build, operate and load platforms. We run a fixed cost business with extreme scalability which has enabled us to drive down unit costs in both our cash and derivatives markets by two thirds during the last few years. We charge the lowest entry fees and all-in transaction prices in Europe. We have integrated vertically to provide seamless "straight through processing", with economies of scope second to none. A world class transaction engine has emerged.

We offer a broader range of products and services than any other comparable service provider: We cover all financial products, commodities, information products and IT solutions. We run other countries' exchanges as well as front- and backoffices for banks and brokers.

We have established the most international range of clients and have expanded into a global geographical reach more than any other company within our industry. We operate the largest worldwide trading network with 670 customers in 19 countries. We are located with significant operations in Switzerland, Luxembourg, London and the US, and of course, Germany; we maintain offices in London, Paris, New York, Chicago, Hong Kong, São Paulo and Dubai. We serve the exchanges in Dublin, Vienna, Helsinki, Zurich, and the CBOT in Chicago with our trading platforms; all in all, we run 19 markets centrally.

We run a diversified, overall resilient portfolio of businesses, with strong brands enjoying a high reputation. We are the market leader or among the market leaders in all of our businesses. Compared to a monolithic business like the one of the LSE, it was growing stronger in past market environments. The portfolio cannot be reconstructed by an investor on the market: While he could take stock in the LSE to represent the cash markets, in Reuters to represent the information products, and in Accenture to represent the systems part, he has no opportunity to buy into the derivatives and the clearing and settlement business. Moreover, the portfolio is not a loose combination of different businesses, but strongly linked through the value chain. This generates ample opportunities for organic growth. With more than 2000 wholesale customers it provides huge cross-selling opportunities. Only five percent of our customer base are already sourcing from the entire range, i.e. from our trading, settlement and custody business. It also provides us with the possibility to further enhance the value chain: Since we got control over Clearstream, we have been eligible for larger banks as an insourcer of their transaction banking, building on our technological skills and on the option to cut out overlaps between the back offices of the banks and our settlement engine. With the acquisition of entory last December we enlarged our value chain with an IT consultancy to help our clients implement our large infrastructure projects, such as the clearing house for equities. With the acquisition of 50% of Spanish Infobolsa we bought content for our Information Products Division, to offer low cost services to smaller bank branch offices.

How did our customers react? Do they understand that they were no longer dealing with a quasi-utility, owned by them, but with a service provider maximizing its own value? We encounter not much of a change in their buying pattern, but a lot of support for our concept. There are exceptions to the rule: A couple of days ago I got a letter asking to cut the price for a certain service by 50%, arguing that we were still making money, while the persons signing the letter were not. But overall our customers care more about the quality of our services and our innovation pipeline, and less about our status as a public company. We do include them more than ever in several important advisory roles: Following the acquisitions of Clearstream and entory, we have for example assembled investors, traders, risk managers and back office people from our clients into a so-called straight-through-processing committee, advising us on the further streamlining of our processes. They seem to like it, and we do benefit a lot!

We have encountered a more surprising change with regards to our shareholder structure. Nobody would have expected that only 22 months after our IPO more than 80% of Deutsche Börse stock would be held by institutional shareholders. More than

50% of our investors are domiciled abroad. What happened? The market environment of the past years has forced our old shareholders to sell, thus realizing substantive capital gains, to bolster their own profit and loss statement. This pattern is repeated within the shareholder structure of Euronext and the LSE. All of this has created a more advanced framework for corporate transactions as basis for further consolidation in Europe.

The market has rated our stock rather positively. Our share price has developed nicely in a tough environment. We have also achieved a promising market capitalization compared to our peers. Our oversubscribed, internationally placed capital increase earlier this year in a difficult environment without a concrete investment proposal demonstrated investors' confidence in management and the company´s growth prospects. The same sentiment underpinned the placement of our commercial paper program at very low interest rates. And when our distinguished panel chairman today decided to sell his stake in Deutsche Börse a few weeks ago, he did not have any problems to build up a book which was oversubscribed several times.

Did the industry develop in the direction we hoped for? Do we encounter the genesis of a real industry for providers of capital market infrastructure? Most of the exchanges and settlement organizations still are not available for capital market transactions, because they have not yet sought a listing. Those that are available, are mostly not for sale, because their owners want to stay in charge. In some cases the regulator would intervene, if one company were to take over the other. And where the players are available for sale and the regulator wouldn't mind, they are expensive – a deal would likely be dilutive, if not smartly constructed.

Finally, exchanges and settlement organisations in Europe are actually pretty much concentrated. Excessive fragmentation is one of the most persistent myths in our industry. The numbers speak a different language. Euronext, Euroclear, the LSE and Deutsche Börse already control 78% of the total European market for exchange, clearing and settlement revenues. Is this much? The largest four competitors in the European parcel service industry combine 53% of the total market, the largest four electricity providers generate 50% of all sales, the largest four airlines have 49%, and the largest four telecom mobile operators control 47% market share. In essence, despite existing barriers to competition, our industry is already much more efficient and consolidated than the public is lead to believe. By the way, the largest four banks control only 14% of the European market.

Now we face market-driven starting positions for the next round of consolidation: What it boils down to is the ability to create value; otherwise the capital markets will not provide additional funds. Price/earnings– values of the LSE, Euronext and Deutsche Börse have already converged. The market is already comparing the major players in terms of their development potential, based on execution skills and value orientation. In terms of efficiency – i.e. the cost/income ratio – a handful of players have significant competitive advantages; however they lack value creation capacity. In terms of the potential to create value – i.e. revenues per unit of invested operating capital –

only a handful of companies have considerable potential; however many of them lack efficiency though. While a couple of suppliers are lagging behind in both dimensions, only one company is delivering both efficiency and value creation capacity above the average. It therefore does not come as a surprise that the capital market expected Deutsche Börse to be the first to approach its investors repeatedly. And we did it with an overwhelming success a couple of months ago, stabilizing our AA+/AA 1 rating by Moody's and S&P.

You and I are witnessing the genesis of an industry: The next steps towards an efficient European oligopoly of infrastructure providers are in sight. To understand this, let's take a different perspective : Most players are still not publicly listed; they are hardly able to make significant acquisitions, or to become part of an orderly capital market transaction. This is the case for Milan, Madrid, and Zurich. The jury is still out if they have not missed the boat to go public altogether. Which investor wants to buy a domestic or regional equity story, if the real game is already a European one? Is the market large enough for others to undertake true IPO transactions?

The three significant exchanges in Europe have gone public, but only Euronext and Deutsche Börse have proven their ability to raise equity capital; the LSE reduced its IPO to a secondary offering, without raising cash. And only Euronext and Deutsche Börse have demonstrated their ability to complete a large deal. Euronext took over Liffe, while we acquired Clearstream. Finally, only Deutsche Börse has so far proved its ability to access the capital market repeatedly, to raise more cash for other large-scale transactions, to leverage the value of its shares, and only Deutsche Börse has been selected to be included in a bluechip index.

3. How will Deutsche Börse continue to improve the performance of its stock?

Is a public exchange organization running this very business model still the right format to approach the next business cycle? We have to face the fact that the volumetrics in the aftermath of the bear market could be quite different to those that we encountered in the past years. Will we face an equities market sclerosis? Do we encounter lasting damage to investor confidence and will equity investing collapse? Will internalization by the large players catch significant market share? Can volatility only go down? Is the fixed interests surge over due to corporate credit problems and government budget consolidation? When will the next investment cycle of the intermediaries come in sight? Will we encounter a new age of tighter regulation, as we have before in comparable markets? Will the regulators close the US markets for foreign exchanges once again?

What are the success factors for growth and sustained profitability? I will certainly not show what we have up our sleeves in public, but let me put forward a few ideas and yet more questions: Process integration and/or cross product integration will matter. Gaining market share in fixed income products could be an interesting field. Will derivatives experience the life cycle of the cash markets, and how can we benefit from this? Can we capture cross border settlement flows? If there is a shift of value added from settlement to Clearing: Should we build a "fat" clearinghouse? Can we exploit broad customer management through cross-selling? Can we design a new pricing model to maximize value? Can we offer new collateral management, hedge funds management, process management, thus capitalizing on the lessons learnt from the transaction banking project? Basel II is creating a “step change“ increase in capital requirements of the business: Can we benefit from disintermediation, centralization, outsourcing? And finally: Is the organization around business units still the right format to deliver all this?

And how will the competitive dynamics develop? Will Deutsche Börse be challenged by client trends and infrastructure providers more than by other exchanges? Will 8 to 10 sell-side players exert monopsonistic pressure? And can we contribute to keeping our 2000 “friends“ – small and midsized, specialized players – in business? Finally, is a new industry model evolving?

Let me close with a couple of heretical ideas that we are discussing internally:

- Should we pursue a combination of vertical and horizontal moves for different parts of the portfolio?
- Isn’t market impact still more relevant to customers than “straight through processing“?
- Should we compromise our rigid value creation paradigm to catch a bigger share of the consolidation to come?
- Will the long term future and growth path be decided in China/Asia, Russia, not in Europe/the US?
- Should we aggressively disintermediate our current customers and turn directly towards investors?

Whatever the answers to all this questions will be – we will make sure that we are not dominated by our environment, but that we will be able to shape our own destiny. Let me assure you that under all circumstances Deutsche Börse will dedicate itself to creating superior customer and shareholder value. By going public we opted for these paradigms.

Thank you for your kind attention.

Exchanges Take Stock

Olivier Lefebvre*

First of all, the change of the corporate model of exchange from non-for-profit mutuals to for-profit service companies is one of the three major trends of the past few years in the world of exchanges. The other two are, of course, the fact that all exchanges went from floor to electronic trading, nearly all of them today. And the third one is the need for consolidation. And there is a link between these three trends. It's indeed due to electronics that competition between exchanges has started. A non-for-profit mutual was a perfect type of governance for a natural monopoly based on physical floor trading. But once you introduce electronic remote access and you start opening markets to competition, the non-for-profit mutual type of governance is largely ineffective for providing the appropriate competitive decision which is needed for an exchange to compete with each other in response to what their clients require. So that's the link between these three trends. All exchanges, or most of them, went private or for-profit. Some of them, the largest ones in Europe, in the Asian time zone, and in this respect America is lagging behind, are now public companies.

To be clear, Euronext could not have been formed at a time of the merger – two years ago, if the exchanges were still non-for-profit mutuals. At the time of the merger, the three founding exchanges, Paris, Amsterdam and Brussels were already for-profit non-listed, but for-profit companies. And that was a condition for the merger. And Euronext would not have acquired Liffe in London if it had not been a listed company at the time of this acquisition. So we see now that being for-profit, being a listed company, is really an absolute necessity to be an active player and an active consolidator in a sector which still needs some consolidation.

Now it's true that the change of paradigm, the change of model initially triggered some concerns by the members in some countries, asking if the exchange was going to take care of the clients or was there any opposition between shareholder value and the benefits of the clients. Well, again in this business as in any other business you hardly create value if your clients are not happy with you. And what we have seen is that today in all our markets there is now a clear understanding of the fact that we can be perfectly

*Summary by the organizer of the Frankfurt European Banking Congress

efficient in terms of shareholder value creation and of course deliver what our clients demand.

Now, what is the key demand of our market participants, these days, normally the members or the financial intermediaries, but also the issuers? It is certainly one of the key points. It's certainly consolidation of the fragmented European landscape. This effort is, of course, top-down with all the efforts of the Commission and the financial service action plan, for example, that should help the European market to integrate, and Baron Lamfalussy is much better placed than myself to comment on this part but we at Euronext have a strategy of doing that bottom-up as well. And we cannot wait, we believe, to have the appropriate fully harmonised regulatory environment to answer practically what our clients want. It's an efficient cross-border market. Now, what is our strategy? Our strategy is based on a very very simple analysis and I will summarise this in three points.

First of all, European markets, if you look at them from a purely national point of view, are rather efficient. The number one problem is cross-border transactions. It is not the inefficiency of each of those national markets. It's cross-border transactions. That's the first point.

The second point is: we want to integrate this market but we don't want to throw away the value of home markets, of proximity, especially in the equity market. Because the equity market, as we all know, is based on information, there is a value of proximity certainly for the mid caps and the small caps. If you take any newspaper in Europe from Corriere della Sera to Börsen-Zeitung or the Figaro, you just have a clear view of how often these newspapers mention a foreign mid cap relative to the domestic market. So proximity is important in the equity market. It has economic value. So once you integrate markets, make sure you do not destroy this proximity value because we are there to create value for the clients and not to challenge the existing value.

And the third piece of analysis is that competition to poach liquidity from one exchange to the other is extremely difficult. We have seen, as it was said by our chairman, that new entrants have had a very hard time, if you see Jiway, if you see Easdaq, now Nasdaq Europe, if you see other competitors, new entrants have had a very hard time trying to poach liquidity from incumbent exchanges. The reason is very simple, it is that the largest component of the transaction cost is the price impact and it is not the technical cost of transaction. Which means that the incumbent exchange already concentrating the flow of buy and sell orders is likely to offer the overall best transaction cost composed with any new entrant. That's one of the characteristics of this business.

So if you look at these three points: as reduced cross-border costs do not destroy the value of the home market and at the same time liquidity is sticky, it is difficult to poach directly. Then what's the strategy of Euronext? It's basically to buy liquidity through active mergers and acquisition of exchanges and we have done that now into five jurisdictions for the derivative market and in four jurisdictions - and admittedly it is not yet totally pan-European but at least it is a good start in four jurisdictions - for the equity market. And so you buy the pool of liquidities. Then you create the synergies by putting all this liquidity on cross-border single systems by harmonising trading rule books in order to give total accessibility to the entire pool of liquidity without destroying the proximity that I mentioned of these markets where they are. So basically you combine global and local dimension by doing that.

So this model is really buying liquidity, creating cost synergies at the level of the exchange but also at the level of the members, creating a cross-border straight-through processing, at least as efficient as we have built it in Europe at the national level in the various countries and, finally, protecting or building on the economic value of the domestic liquidity and proximity dimension.

Now this model works today and is being more and more recognised not only by the users but also by the analysts. As a listed company we have seen now the first results of this model.

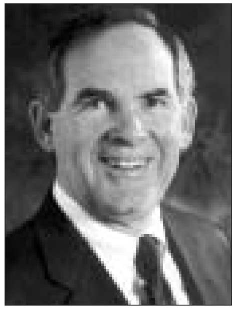
The first three initial markets – France, Netherlands and Belgium – are now fully integrated. I am talking about the equity market. They are fully integrated in terms of technology. They are on one single trading platform in terms of the rule book, with what we call the rule book, one which is a cross-border rule book recognised by the various regulators and it is done also for these three markets at the level of the central counterparty, Clearnet and Clearing 21, but technology Clearing 21 are not operational on these three markets. And the settlement integration will be done by Euroclear in the next year. So in this area it's largely underway to become really from the technical point of view, transactional point of view, a cross-border domestic market, if I may say so. Synergies are starting to show at the level of Euronext, certainly, but also at the level of some members and our clients are adapting to this integration, if you look at the internal optimisation. This was decided with some banks like ING, Fortis or some others in order to grab the benefit of the Euronext integration in terms of their own internal cost of front and back office. You can see how, practically, synergies can also benefit the clients.

Now, that's the strategy and indeed I want to say a few words about the change in the regulation and the opening-up of competition. I think the new investment service directive is a key cornerstone in the financial service action plan in order to create a true pan-European competitive landscape. We have said very clearly that we welcome competition. Today, competition is still constrained by too many hurdles, too many regulatory limitations. And we want genuine competition on a pan-European scale, which does not yet exist today. And this is not only true between regulated markets but also with other types of so-called trading venues. But in order to grab the benefit of this competition in Europe, we should make sure that the regulatory environment matches some of the concerns that this type of competition may create, certainly in terms of best execution. I think everyone will admit that point, but also in terms of transparency. And that's a more delicate debate obviously. Our concern that we have waived is that fragmentation of the market should not lead to an impoverishment of the overall price formation process. In other words, all the information which is conveyed by the floor warders, by the activity, even if this floor warder is more decentralised than in the past, is fragmented; the information that is conveyed by this activity wherever it is matched should participate in the overall price formation, if we do not want to damage the quality of the markets altogether.

I will not comment on the recent ISD, maybe we will discuss this in the panel later on. But we are pleased to see that the concern is being taken as an issue. We have no time to analyse the exact proposal of the Commission, the very recent one, to see if it matches the concern but at least the concern is addressed.

Now there is a paradox, and I want to conclude on that. In the recent discussion around the ISD there is, as I said, the number one problem in Europe, which is really to reduce the geographical fragmentation of the market and the extra cost that is created in the case of cross-border trading. And still, we spend 80% of our time, when we discuss the ISD, on a different issue, not on really solving this one, but on talking about the risk or the benefits of another type of fragmentation. And that's a little bit of a paradox of the discussion in Europe, is that we are a little bit forgetting what the problem number one is and that we are a little bit distracted from discussing this new type of potential fragmentation and that is something we should think about. Thank you.

Exchanges Take Stock



Hardwick Simmons*

I can certainly give you the US view. Good morning everybody. Joe thank you, and thank you all for inviting me over here today. We Americans aren't always these days confident that we are welcome in Germany, but I hope we are. You'll love us in the end.

Nasdaq is a little bit of a different beast and I want to take this question from that side. Unlike the Deutsche Börse and unlike Euronext, each of which essentially started unchallenged in their individual countries, Nasdaq started off as number two, a clear number two. Nasdaq's history, for those of you who don't know it, was that it really began back in 1970/1971. In the old days in the securities business if I wanted to buy an unlisted stock in the United States what I did was I gave my order to my broker. My broker then checked two additional markets to make sure that the price he would offer me would be as good as the best price that at least two other market makers might offer and then executed my transaction. That was a messy system that did not in any way assure me that I got the best price, because there are of course many more than two market makers in each of these other stocks. Therefore, an electronic market place was created into which all those who made markets in a specific stock had to put their quotes. Indeed then I could as a market maker look at that quote board and make sure that I was then offering my client the best price, as a buyer or a seller. That's thirty years ago. Nasdaq has come up from there.

Nasdaq was also helped in its creation by some very enlightened tax policy. We have not seen this in Europe yet. For instance, at the very bottom of the young companies that make up so much of Nasdaq's 3,800 company roster are companies that were created by venture capital that was provided by non-profit institutions. Non-profits being non-taxed in their endowments, with a longer investment cycle because their institutions will use that money over a long period of time, could take risks that others couldn't. Secondly, it was helped in the 1970s and 1980s when, in order to make themselves more competitive, US companies stopped providing defined benefit pension plans and moved to defined contributions, something that the countries of Europe have yet to do. What that did was that it made every individual in the country in a sense his own investor because if he left a company and moved to another he took his pension with him

*Summary by the organizer of the Frankfurt European Banking Congress

and invested it himself. That is the reason why today in the United States one of every two adults is directly or indirectly invested in the equity market as opposed to one in five here in Germany. Those in turn helped create, as I say, Nasdaq. Nasdaq grew because it recognised pretty quickly that it was not going to be able to challenge the New York Stock Exchange for the old listed companies that existed prior to 1971. Instead it had to find a new source and of course that source was the capital formation aspect which is I think primary in the brand of Nasdaq. And today, as you know, the number of new offerings in the US is down by about 85% from what it was two years ago, but in most years Nasdaq will do about 75 or 80% of all the new offerings that come about in the US.

Now, what we try to provide is just exactly what you have heard Werner talk about before and that is hopefully what an exchange listing provides, namely a higher multiple per company and therefore lower capital costs. And if indeed we can continue to do that, which I believe we can, we will in turn maintain the momentum that has been built into Nasdaq. But key to it is a number of concerns that I have at the moment and that I think are the concerns we all might share.

First, you got to have standards for these young companies just like you have standards for their older brethren. And where we have dropped our standards we, in general, and this I think is true universally, have gotten ourselves into difficulty.

Second, we need market makers. And as you know, Nasdaq is a big open electronic exchange where customer orders and market maker quotes interact electronically. It's a very quick market in the sense that it shows you five levels deep on either side of the best bid or offer what's in the market and tells you that if you click on one of those offerings that within two tenths of a second your order will be filled. To give you a contrast, for instance, on the New York Stock Exchange where all orders go down to a central point governed by a specialist, the average execution takes about seventeen seconds. On an active day, in New York, a stock like Cisco or Intel will trade ten times in a second. It's price will change ten times a second. Seventeen seconds says there can be 170 price changes between the time that you actually enter your order and that order gets executed. Nasdaq is in comparison, at two tenths of a second, of course, much more efficient.

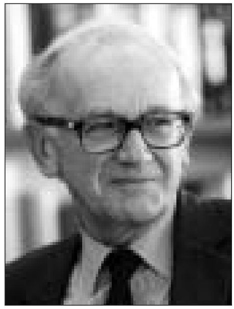
But in turn we are concerned at the moment about research problems. We have as you know, and you have all read, a contretemps in the US about the linking of investment banking with research. Research as a result it appears is going to lose its primary funding source which is the investment banking business. If that's the case, research will be cut back and the companies that will suffer most will be the young companies of which Nasdaq is a parent. To give you an example: Nasdaq has about 3,800 companies listed on it. Of those 3,800 companies, about 1,500 have two or fewer sources of research. As a result, if there is much of a cut-back, the difference between remaining private and becoming public without somebody to follow your stock, is significant.

The second, of course, is the advent of decimals in the US which have significantly decreased the spreads, the old piece between the best bid and offer that many of us as market makers used to claim as our own and enabled us to make markets on either side of the security in some size. With decimals and the advent of electronic communication networks - ECNs - those spreads have narrowed significantly such that many have begun to drop out of making market in specific stocks.

There are now about 1,500 companies which have two or fewer market makers now. If indeed we lose research and we lose these market makers, in turn the engine of entrepreneurship, of capital formation in the US, I fear, will be damaged. Which is why in all the corporate governance discussions going on, Nasdaq may be playing a slightly different role than the New York Stock Exchange and/or others who are engaged in the fray.

So, in summary, I would say that unlike Euronext and the Deutsche Börse, Nasdaq has played a very different role. It is the capital formation role that is key and, although it can arguably be said that it is the world's largest exchange in the sense that in the cash market only as opposed to one of a multi-facetted exchange, Nasdaq does trade 1.9 billion shares a day, the most of any exchange in the world. Nonetheless, it is right now, threatened somewhat by the current environment. The fact that value has now the upper hand over growth, should not end up with abondoning the policies that have generated the productivity, that the US economy needs at the moment.

Exchanges Take Stock



Baron Alexandre Lamfalussy

I am broadly sympathetic to the process of consolidation under way in the regulated markets. As we have just heard, there are different strategies at work – but this is how it should be. Our for-profit stock exchanges are working reasonably well and are cost-effective. But I have concerns about the organisation of post-trading at the European Union level. I propose to share with you these concerns.

In the good old days – or, if you want to appear less nostalgic, in prehistoric times – we had well-functioning post-trading systems located where the trading took place. These were structures with strongly monopolistic features; they were also strictly regulated (or even operated) by public authorities; and market participants had well-defined functions. Some of this still exists, but post-trading today is dominated by the same influences which have transformed trading itself: deregulation and global competition; spectacular progress in information and communication technology; the introduction of the euro; and the fully justified political drive towards an integrated, liquid, broadly based and transparent European securities market. The practical manifestation of this drive has been the Financial Services Action Plan as well as the mandate given to the Committee of Wise Men which I had the pleasure of chairing.

These influences have turned stock markets into for-profit organisations and have led to enhanced competition, to the blurring of specialisation and, most important, to the increasing dominance of cross-border transactions. And here lies the challenge: while our domestic post-trading arrangements have remained reasonably efficient – by which I mean that they are cost-effective and safe – these arrangements do not combine to form an efficient EU-wide post-trading system.

The visible symptom of this inefficiency is that the sum total of post-trading costs is too high – higher than domestic costs or post-trading costs within the borders of the United States. We know, of course, that the information content of any such comparison crucially depends on the methodology which is used. Even the apparently simple comparison of settlement fees turns out to be tricky, and the difficulty materially increases when one wants to take into account the various additional services provided by the securities depositories. In addition, settlement fees are far from being the only costs incurred by a customer. As a result, I have seen estimates ranging between multiples of 2 and 10 for cross-border operating costs within the EU, in comparison with those in the

United States. But I have seen no estimates yielding a multiple of less than one – and this would seem to confirm this inefficiency.

We have to look behind this symptom if we want to find genuine remedies. The economist's instinctive assumption is that higher costs have something to do with barriers to integration or with a lack of competition or with a combination of both. This assumption is right.

There is little doubt that there are serious barriers to cross-border integration, which have been well spelt out in the remarkable Giovannini Report. There are differences in market practices and in what you might call technical requirements. More seriously, there are differences in our legal systems and taxation. Finally, and regrettably, there are more or less apparent barriers resulting from national protectionist instincts.

Similarly, there is not much doubt that we are far from having fair and competitive post-trading structures. Fairness and competition require open and non-discriminatory access to post-trading structures – not only in principle but also in practice. This means, broadly speaking, that securities purchases or sales should not be unduly influenced by the location of counterparties or of post-trading structures. At present they are.

How can the twofold objective of removing the barriers to integration and of ensuring a competitive post-trading environment be achieved? And what should be the respective roles of market participants and public authorities?

As a matter of principle, I would still stick to the point made in February 2001 in the final report of the Committee of Wise Men on the Regulation of European Securities Markets, which said: "The Committee is convinced that further restructuring of clearing and settlement is necessary in the EU. The process of consolidation should largely be in the hands of the private sector. Market forces should mainly determine the contours of European clearing and settlement …". But we also added that: "This does not mean that there are no public policy concerns at stake…".

It may be useful to remind ourselves that public authorities did play a role in the past in setting up current infrastructures, and not without success. In the 1970s the SEC played a major role in restructuring the US securities settlement arrangements. The Banca d'Italia's part in establishing the new Italian settlement system in the 1980s is just as well-known as the role played by the Bank of England in setting up the central securities depository in the UK in the mid-1990s. Times have of course changed, some of you may argue, and historical precedents cannot be determining guides. So here are some more relevant arguments in favour of a division of labour between market forces and public authorities in the present situation.

One of the major responsibilities of governments is to take an active part in removing the barriers to efficient EU-wide post-trading arrangements. Harmonisation of market practices and the dismantlement of technical obstacles can naturally be left to market participants, but barriers resulting from deep-seated differences in our legal systems or from taxation must be handled, by definition, by public authorities. Moreover, governments should resist the temptation of protectionism, even when protectionist initiatives are requested by market participants. Not an easy assignment.

As regards competition, public authorities should carefully monitor the development of post-trading structures. Do these developments comply with the crucial requirement of open and non-discriminatory access? Do they allow effective competition? Do they tend to reduce costs? It will not be easy to give unambiguous answers to these questions. Market participants should be given some time to be able to demonstrate that their initiatives are moving in the right direction. In particular, patience will be required to see whether the "natural monopoly" argument still holds in an environment of exceptionally fast technological change.

Finally, I would plead in favour of improving the regulatory and supervisory framework at the EU level. There are two good reasons for this. The fragmentation of our present framework in this field constitutes in itself a non-negligible barrier to private sector cross-border initiatives. At the same time, the safe working of post-trading systems is of crucial importance for preserving systemic stability, and therefore requires close co-operation between central banks and securities regulators. We now have a set of recommendations which have been worked out at the G10 level by the Committee on Payment and Settlement Systems and IOSCO on standards for securities settlement. Work is now being undertaken to see how these "global" recommendations should be implemented at the EU level. This initiative deserves full support from all European authorities as well as market participants.

A Constitution for Europe

Johannes Rau

I don't know if anyone has ever worked out how large the total assets of the banks are which are represented here today. It is beyond doubt an impressive figure which just goes to show that there are people gathered here who have influence and can actually effect change.

European integration needs impulses. It needs impulses and it needs the active involvement of all those people who can and want to help shape Europe. Banks play an important role in the economic process of all states and so play an important role in the process of European integration.

I am glad that you come together here in Frankfurt each year to discuss European subjects. Banks have influence and they have power and since they have both, they also bear social responsibility way beyond their responsibilities to their employees, customers and shareholders.

I do not want to talk to you today about money, although there would certainly be much to say about it, particularly in the context of Europe, but I have the impression that public criticism of the euro has weakened considerably. Naturally, most of us will continue to convert euros into deutschmarks and vice-versa in our heads for a long time to come whenever we go shopping, but even that will soon give way. Seen economically, the common European currency was, all in all, a good, sensible and correct step.

Another matter I do not wish to go into here is the European Stability Pact and the discussion going on about it at the present time. What I would like to talk about is the political future of Europe.

In two weeks' time, at its summit in Copenhagen, the European Union will, in all probability, decide to enlarge itself by eight central and eastern European countries and also Malta and Cyprus. In the coming year, a decision will also be made on a European constitution based on the results of the European Convention. We are currently witnessing what must be the most decisive phase in European cooperation since the 1950s.

Then, it was a matter of securing peace and stability for a Europe ravaged by war and of creating new prosperity. Today, now that we have overcome the division of Europe, it is a question of those people who were not able to decide their own fate during the Cold War era now being able to enjoy the benefits of European cooperation. At the same time, we must reform the legal and political structures of the European Union so that an enlarged community of more than twenty-five states can retain its capacity to act, internally as well as externally.

Globalization poses major challenges for the European states. No individual European country can deal with them alone. It is only together that we Europeans can react to the globalization of trade and financial flows. It is true that no other region in the world is so well prepared for globalization as the European Union. And in no other region of the world do countries work so closely together. And yet it is only if we intensify our cooperation that we will be able to exploit to Europe's advantage the opportunities offered by globalization. That is what we have to do now!

Previously we debated the alternatives "enlargement or deepening". Today that is no longer the question. We must do both, simultaneously. This is an extraordinarily difficult task. Nevertheless, I am convinced that we can manage it. However, limits to both enlargement and deepening will become apparent that were not yet an issue for the founding fathers of European cooperation. Today, we must ask ourselves the following questions:

- How far should the European Union be enlarged?
- How should we allocate the various responsibilities so that they can both be fulfilled efficiently and controlled democratically?

Each of these questions deserves to be discussed more deeply than my talk today will allow. I therefore wish to say only this: on no account can there be another big enlargement round. And as for the question of the division of competences, we need to find a solution today. On no account should we have to hold a new convention or a new intergovernmental conference to reform the European treaties every few years. What we need is a permanent framework that provides confidence and certainty. I agree with Valery Giscard d'Estaing, the President of the European Convention, that once they are implemented, the results of the Convention must shape the European Union for many years to come.

A few weeks ago the Convention presented its first draft, or rather, a framework, for a European constitution, which seems to me to be an excellent basis for the concluding consultations. It is a good thing that concrete proposals are now being discussed.

Today, I wish to take up a few questions that are raised by the current debate. First, the familiar question about the finality of European cooperation: what is the European Union going to be in the future?

First of all, I am convinced that the European Union will not become a federal state, at least not at any time in the foreseeable future. Here again, I am in agreement with Valery Giscard d'Estaing, who does not wish to talk of a United States of Europe, but of a United Europe. Of course, we will have to find a name that is appropriate to the particular nature of European cooperation. The European Union is without parallel in history and in the world today. Countries collaborate in it voluntarily and on equal terms while ceding some of their sovereignty. I, therefore, like to refer to it as a federation of nation-states.

We need clear rules for such a federation of nation-states of twenty-five and more sovereign member states to function. For me, the question of whether the term constitution is appropriate for it is of merely academic interest. Call it, if you will, a "constitutional treaty" or a single treaty resembling a constitution as Prime Minister Paavo Lipponen of Finland recently suggested. Whatever the case, it will have to be an international agreement that sets out the rights and obligations of the member states, the common institutions and their responsibilities and a charter of fundamental rights which can be invoked by the citizens of the Union. It is therefore a question of an agreement that shows how the "United Europe" is constituted. A European constitution of this kind can and will have the effect of conferring an identity.

One obstacle to a "United Europe" which is raised from time to time is that there is no European nation. But is it not gradually emerging at the same pace as Europe is growing together? Europe's citizens have a common currency, they vote in joint elections and European public opinion is emerging not just as a result of the way the media does its reporting. Among all the diversity there is also an awareness of the European identity. It is the result – paradoxically – of cultural similarities and political conflicts that have been overcome. The nations are part of this identity. The historian Hermann Heimpel put it this way: "The fact that there are nations is, historically speaking, what makes Europe European".

Like the European currency, a European constitution can contribute to a common European awareness. If the complicated regulatory framework of the treaties from Rome to Nice are summarized in a clearly structured European constitution and if the European Union receives its own legal personality, then European cooperation will be more easily comprehensible. We all know how important transparency and openness are if the people are to be won over to a greater degree of common European action. After all, it is the concern that decisions cannot be understood or influenced that is at the root of many people's euroscepticism.

In my eyes, therefore, transparency and openness represent a very important first requirement for a European constitution.

Allow me to spell out three further expectations for a European constitution:

I expect the European Charter of Fundamental Rights to be included in a future constitution. It sets out a binding framework for the European institutions and also stipulates the areas in which the member states must implement and apply European law. It thus protects the liberties of its citizens. It also shows that the goals of the European Union are more than just safeguarding the prosperity of its citizens and advocating peaceful coexistence worldwide. I am pleased that on this question there is a far-reaching consensus in the Convention.

My second expectation concerns the division of tasks between the European Union and the members states. Obviously, there is much that has to be dealt with at the European level. The single market, for example, can only work if it is based on common rules. However, there is much that is better off in the hands of the member states, for example, in the fields of education and culture. Citizens must be able to see clearly who is responsible for what. Then perhaps the game of passing the buck that some are so fond of playing in Europe will also stop.

Naturally, a division of responsibilities that has been agreed on once is not set in stone forever. Yet everything must be based on the principle that tasks must be dealt with at the level at which they provide the best results in the eyes of the citizens.

My third expectation is that we should also strengthen the Union's democratic legitimacy. This would contribute to the credibility and transparency of European cooperation. Wherever political power is exercised, it must also be democratically legitimized. For this reason the European Parliament should participate on equal terms in the legislative process in the European Union. The European Parliament should also have full budgetary powers rather than the limited ones it has now.

In any case, it would seem sensible to me to create a second chamber of the European Parliament, to be formed from the Council of Ministers. Moreover, the work of the Council of Ministers could be divided into a legislative part with open sessions and – as has been the case until now – a closed part in which, among other things, questions of foreign and security policy would be discussed.

The issue of democratic legitimacy also plays a role in the question of the way the European Union is represented abroad. Improvement in this must not result in the weakening of the internal institutions of the Union. I therefore advocate strengthening the role of the Commission and enhancing the legitimacy of its President by having him elected by the European Parliament. Should the institutions decide to install a European President alongside the President of the Commission, then he must have the same democratic legitimacy.

Right from the beginning, European integration was characterized by states both large and small participating on equal terms. Smaller member states, such as the Benelux countries, have provided outstanding contributions to European integration. They have taken mediating positions whenever there have been tensions in relations between the large members. The enlargement of the European Union will also entail an increase in the number of smaller member states.

This must be taken into consideration when we vote on decisions in the future. We ought to think about taking account of population numbers and introducing a double majority. A double majority would mean that for decisions to be agreed in the Council, a majority of the states would be needed which until now have had a certain number of votes while, at the same time, a majority of the population of the European Union would now also be represented.

So much for my ideas for a European constitution, which could form the basis of a future European Union or a United Europe. This matter is of such importance that I hope that there will be a broad public debate about it. As representatives of European banks and companies you can make your contribution to this debate, for the future of Europe affects us all.

The dream of a peaceful and united Europe is centuries old. Many have argued for it in their time, among them Henry IV, Victor Hugo, Aristide Briand, the Heidelberg Programme of Germany's Social Democratic Party in 1925, Winston Churchill and Konrad Adenauer.

More than fifty years after the end of the most horrific of all European wars, which led Europe towards the abyss, and more than ten years after the end of the Cold War, which caused the division of Europe, this dream can finally become reality.

We are all aware that nothing is as potent as an idea whose time has come. I am convinced that the time is ripe for a united Europe.

Constituting Europe

Klaus-Peter Müller

Ladies and Gentlemen,

To continue our discussion on "Constituting Europe", we have assembled a very competent and appropriate panel. I welcome here on the podium:

- Professor Danuta Hübner, Minister for European Affairs of the Republic of Poland and member of the Convention on the Future of Europe;
- Professor Romano Prodi, President of the European Commission, and
- Mr. Henning Christophersen, Member of the Praesidium of the Convention on the Future of Europe.

First of all, let me thank you all for joining us.
In such turbulent times, when the urgent day-to-day problems are tending to push everything else into the background, it is imperative that we do not lose sight of our long-term goals. This holds true for the management of a company, but it is also important for the politics of European integration.

The euro was the last step for the time being towards economic integration. And the transfer of responsibility for monetary policy to the European System of Central Banks also introduced shared control of economic policy. But where do we go from here? Only now – in other words, rather late – is the spotlight switching to the "final questions" relating to the ultimate goal of the EU's integration.

President Prodi, we would like to know what the Commission, and you personally, expect from the Convention. And here in Frankfurt, you will certainly take the opportunity to comment on the future of the Stability and Growth Pact.

Constituting Europe

Romano Prodi

I am very pleased to be able to discuss these important issues with you here today. I was also very interested in President Rau's address. My distinguished co-panellists will certainly comment on enlargement and the European Convention from their own viewpoints. I want to look at them from the Commission's perspective.

I believe we need a wider, but also a stronger, EU. Enlargement and consolidation are both vital for the EU's future. By stepping up our internal cohesion through stronger policies and more effective decision-making we can make enlargement a success. We are now in the final stages of accession negotiations with the ten candidate countries. We aim to sign the Accession Treaty in spring next year. At the same time, the European Convention is now entering its decisive phase. The impending enlargement represents a giant step towards the full realisation of the European project.

European integration has brought us half a century of peace and prosperity. And now the other half of Europe is set to enjoy the same benefits. Looking to the EU as an example, a vast slice of our continent has cast off dictatorship and embraced stable, participatory democracy. Enlargement is forging ahead thanks to the political will and courage of Europe's peoples and leaders. And to their far-sighted vision of history.

From this broader perspective, the cost of enlargement is slight compared with the benefits in terms of cross-fertilisation and wider market opportunities for both current and prospective Member States. And that cost is negligible when set against the political, social and economic price we would pay if enlargement did not go ahead.

Admittedly there are still shortcomings in certain sectors and countries. These have to be made good before accession. The Commission will work with the authorities in the acceding countries to sort out any problems in good time.

The second aspect – closer integration – brings me to the Convention. The institutional reforms that will emerge need to be bold and far-sighted too. Unless the institutions are reformed in a radical and intelligent way, the success of enlargement could be in jeopardy. The present institutional rules can work in a condominium but not in enlarged Europe. Our fellow citizens need to understand and approve of the tasks and powers of tomorrow's EU and its institutional framework too. The time has come for a European constitution.

The Convention has made amazing progress. Those who first scoffed at the Convention – which they called a "talkshop" for Brussels insiders – are now silent, and rightly so. One very strong and positive signal is Germany's appointment of Joschka Fischer as its representative and, of course, France's new appointment of its Minister of Foreign Affairs, Mr. de Villepin.

In two weeks' time, I will be presenting the Commission's ideas on the EU's future institutional architecture to the Convention. Today I want to tell you what I expect from the Convention personally.

First, I want a more effective Union. People do not understand why we cannot fight cross-border crime more effectively, coordinate our economic policies better and speak out more forcefully in the international arena.

Secondly, I want a simpler, leaner Union. The European Union's legal framework has grown too complex. People do not understand how the Union works and what it actually does. And I do not blame them.

And thirdly, I want an even more democratic Union. The European Parliament must play a stronger role, both in legislating and in choosing the Commission President.

Let me say a bit about those three expectations of mine.

As practical people, you bankers will see why I am starting with a more effective Union. No one in Brussels wants a European superstate. But we should be clear what sovereignty is all about. Robinson Crusoe may have enjoyed unfettered theoretical sovreignty over his island, but he could do nothing to alter his fate.

In a globalised world, we need to pool individual states' sovereignty more than ever before. We need to cooperate much more closely if we want to help shape the future – both within the Union and beyond. People want national police forces to cooperate more effectively. This will enhance security and help fight cross-border crime, trafficking in human beings, arms and drugs, and terrorism. There should be no loopholes for criminals.

There are two more reasons why we need a more effective Union: for better economic policy coordination and greater influence in world affairs – two areas you bankers are very conscious of. Economic policies are – and will continue to be – a national responsibility. But we need to coordinate them better at Union level. And recent months have shown we need to be stricter.

As the Italian Prime Minister who promoted and approved the Stability and Growth Pact and led Italy into the common currency, and as President of the Commission, I am and have always been a strong supporter of the Maastricht Treaty, the Stability and Growth Pact, and Economic and Monetary Union. Growth and jobs depend on stability. Thanks to the Pact, we have achieved great goals. But we must not rest on our laurels. We must ensure that the Pact applies both during periods of high cyclical growth and in recessions, and to small and large Member States.

We can strengthen the Pact by interpreting and applying its rules intelligently. The spirit is intelligent, only the letter is stupid. Only thus can we meet the challenges facing the Union in the short, medium and long term. Because stability and growth are not incompatible: both can and must be achieved. In line with that approach, we will be putting forward proposals next week to improve economic-policy coordination and increase transparency and discipline in the way the Pact is implemented. Our proposals will also seek to underline the preventive and constructive aspects of economic-policy coordination.

Laying down rules is not enough: we also need the authority to make sure the rules are followed. And our decision-making structures must meet the need. With the Treaty as it stands, much can be done. But it will have to be reformed for some purposes. The Union also needs to be more effective so it can wield greater influence on the world stage. People cannot understand why, despite its economic power, the Union has so little political clout on the international scene – why this economic giant is still a political dwarf. The reason is quite clear: we have no Common Foreign and Security Policy worthy of the name.

Some believe the solution is to put another player on the Union stage: a "President of the European Union" appointed by the European Council to represent the Union internationally. I am not convinced. Would people really understand the Union better if we created another representative? Would they identify with a President selected by a small group of individuals behind closed doors? And who would this President be accountable to? Who would actually represent the Union? The new Union President, the President of the Commission, the High Representative, or the Commissioner for external relations? Or even the heads of state or government or the foreign ministers of the Member States?

I believe what the Union needs is greater ambition – not new institutions and competing bureaucracies.

In place of that range of Union foreign policy representatives – and without adding an extra one – there should be only one "European Union foreign minister" – the European Union Secretary. As a member of the Commission, he or she would be able to call on the whole external-relations machinery of the Union and the Member States. Obviously, such a European Union Secretary must be appointed by the Member States and be accountable to both the European Council and the Commission President, at least initially. Some may feel this is over-ambitious. But the alternative is clear: to go on being a political dwarf.

The second thing I hope the Convention brings is a simpler, leaner Union.

The Treaties have become too complex, too unwieldy, too long. We need to simplify them. We must aim for a short, easy-to-read constitution – a constitution you can understand without being a lawyer. We must make it clear that the institutions have different roles to play.

The constitution should state quite simply that Parliament and the Council – voting by a qualified majority on Commission proposals – adopt Union legislation jointly while the Commission acts as the Union executive.

We must make who does what clear. A "catalogue of competences" set in stone may seem appealing at first sight. But that is not the solution at Union level. We must not forget that the Union's success depends on its ability to respond flexibly to new challenges. I am convinced we must resist the temptation to score points for what looks like clarity. In the long run, such an inflexible approach could come at a high price.

The third major result I expect from the Convention is an even more deeply democratic Union.

To say the Union and its institutions lack legitimacy or suffer from a democratic deficit is a myth. I strongly reject it. The new constitution is, however, an opportunity: it gives us the chance to adapt our response to the stage of integration we have reached.

I believe that the President of the Commission should be elected by the European Parliament and confirmed by the European Council. This would generate public interest and make our citizens feel more involved in the European project. I also believe the Commission should be politically accountable not only to the European Parliament – as is the case today – but also to the European Council. This would not undermine the Commission's essential role of honest broker and guardian of the Treaty. On the contrary, it would strengthen the Commission in its role as it prepares to take on new tasks in the general interest of the Union. The European Parliament should also co-decide all Union legislation.

The system for financing the Union should be less automatic too, so Parliament can decide on revenue as well as on expenditure. After all, democratically elected parliaments throughout the world do this – with the sole exception of the European Parliament.

The contours of tomorrow's European Union are taking shape. But enlargement and deepening must be addressed jointly. Because our wider Union needs to be both effective and cohesive, strong and caring.

And now I look forward to hearing what my distinguished co-panellists think, and, of course, to a lively debate.

Constituting Europe

Danuta Hübner*

I should probably say that more and more often I feel sorry that I come from a big country because everybody is just throwing it in our face: you are the biggest among the candidate countries, and that is not always a positive remark, I must admit. Dreams have already been mentioned today by President Rau and I think that when we think about dreams and visions it is always important to keep in mind that one great European vision has already been realised and after a disastrous century most Europeans are living in freedom, are living in peace and a substantial number of them also in a degree of prosperity. And I must also say that in large measure this is the achievement of the European Union, which first united the western part of our continent, then expanded to the South and North and now is about to welcome the central and eastern parts of Europe.

Let me also say that the accession of Poland and seven other central European countries to the Union is in a real sense reconstituting a Europe which we have dreamed about for so many years. But let me also say that as a member of the European Convention, I take some pride in being part of a major effort to think through the vital questions which are affecting the future of the Union, including that of making a contribution to the Union. And we will put forward our ideas, hopefully unanimously, to the intergovernmental conference which follows the end of the Convention and I also hope, probably I should say on behalf of all current candidate countries of the future member states, that we will all participate in this process with the full right to decide. The point that I would like to emphasise, to make but also to emphasise today, is that our future in Europe depends heavily on the quality of our economic policies. And the Convention is discussing a whole range of issues, some of them very complex, some of them very abstruse and, sometimes we think, sitting there, that they are designed to ensure that public interest is switched off, and this is our major problem discussing those complex and difficult issues, and at the same time trying to reconnect the Union to the public.

I strongly believe, while discussing such difficult issues as the design and contents of the future constitution, that we should not allow ourselves to forget that if we do not get

*Summary by the organizer of the Frankfurt European Banking Congress

the economics right, all our great ideas will be worthless and submerged in economic decline, with all the political dangers that that situation brings.

There is no doubt, and in this room probably you have already discussed it today, that the Union's economic performance also affects its capacity to play a major role in world affairs. And in fact President Prodi has referred to the importance of economic coordination, economic policy coordination, and the need to speak with one voice, if not with one mouth, internationally. These things are really linked, and we are just on the point of concluding the report of the Convention's working group on the external relations and we make significant proposals on the organisation of EU external policy, to make it more efficient and effective. But my feeling is that these proposals will be of little use if our economic performance in the medium and long term leads to a loss of influence in the world.

Analysis shows us that in the past high growth rates in Europe have generally been associated with significant increases in the use of production factors. But Europe today is going through a long period of a declining labour force and above all a reduction in the number of young, energetic people joining the labour market. And we should not believe that migration is going to solve our problems. It will play a part, maybe in some countries a major part, but it will not solve anything in the long term. Our hope has to lie in rapidly rising productivity which will be associated with technological progress through new investment in Europe. And that's why at the Union level I am so attracted to the Lisbon process which sets objectives for innovative growth, for training, for education, for the development of entrepreneurship, all of which will be necessary to achieve political and social progress. And it also underlines the need for flexibility and for good, but hopefully less, regulation.

And I think we need desperately in Europe to be successful in the years to come to get all those people who are unemployed back to work, and we need to invest in education and training and research to enable the declining cohorts of young people to contribute effectively to raising the national income of Europe. In my view, we will not do this by raising taxes and maintaining the privileges of certain groups in society. I think we need more flexible markets if we want to be able to overcome all those difficulties in the medium and long term. And without this, we will certainly not achieve our social and political ambitions.

And in Poland we also have our economic reforms to undertake and there is no doubt they will continue to be painful. But we have a good track record on reform which has been the combination, as you know, of both transition to the market economy but also the preparation for accession to the European Union. And all these changes are continuing. Also in this context, before I switch back to the Convention, because I think this is an extremely important additional factor which we must bear in mind all the time when we are discussing how the President of the Commission should be elected or if we should have a President of the Union and who that should be, I think we should also see the extremely important impact which enlargement is already having and will continue to have on the changes in the European Union.

And just a few words on the current state of the accession negotiations. President Prodi has mentioned that in Copenhagen we will see the end of this process. Why am I mentioning enlargement here? Because the terms of the accession matter strongly not only for economic and financial reasons but also because we must get the Polish public to agree to them in the referendum. And my view is that in spite of the apparent impressions we all have, people are less concerned about financial transfers. They rather want to be treated as full and equal members of the Union.

I also feel tempted to admit that this enlargement is not characterised by a particular generosity. Nevertheless, I regard the long-term arrangements as fair and Poland will definitely benefit from full participation in all decision-making institutions, especially if we have an impact on the improvement of those institutions. We will receive structural funds to help us develop the urgently needed improvements. And, of course, we know that in the longer term our future will be essentially determined by the quality of our own economic policy.

However the terms of accession worry me in the short term. Because the combination firstly of paying full contributions to the budget from the first day of membership, the co-financing of structural funds, the pre-financing of other Community measures and finally, the implementation of all the remaining Community acquis, will place a major strain on budgetary resources. And in the absence of strong growth we might be faced with the choice between raising taxes, and cutting borrowing, while what we need is the opposite: to cut taxes and stimulate investment.

And today, I think there is no reason to doubt that we will have enlargement in May 2004. And let me simply say that we in Poland, but I think also other candidate countries, cannot afford to join a Union which is shutting its mind to the reforms necessary to keep it competitive, innovative, in an increasingly complex global environment. We can have no interest in a protectionist subsidy-dependent culture because in such an environment catch-up growth will be impossible and the modernising development of Europe will be delayed. And that is why – and here I am going back to the Convention – in my personal capacity in the Convention, I have always strongly backed many of the reform proposals which aim at making the Union – as President Prodi said – more effective, more efficient. In a globalising world we cannot take so long making decisions that the decisions are irrelevant by the time they are taken. And this is especially true in areas like financial services but also external policy or justice and home affairs. And the extension of majority voting, for example in the Council, is certainly important here as this also ensures a better strategic planning capacity for the Union. On economic policy, the discussion in the Convention has shown that members do not want to change the institutional or decision-making structures in Monetary Union. They believe they need time to achieve total credibility. However, on fiscal policy there is a tendency to suggest that stronger coordination would be useful.

The discussion on economic policy-making we had in the Convention in fact reflects the overwhelming significance of economic policy for the future of the Union. I believe that in this ongoing debate we should be more concerned with making the Union a dynamic economic entity than with just satisfying the institutional desires of interest groups.

Let me finish by mentioning a particularly central European concern. Europe did not finish years ago at the river Oder and it will not finish at the river Bug in the near future. In Poland, we have invested much of our efforts since 1999 in developing good relations with all our neighbours and also in attempting to create an area of stability and peace in central Europe. And I think this is something we are really bringing into the European Union in joining it. And after accession I believe that we must continue to develop strategic relationships with the Ukraine, Russia and Belarus; these are clearly European countries in all the discussions of where Europe ends. We have many interests, as President Prodi said, in working together, in being together and in sticking to each other. So constituting Europe should not therefore be considered as a narrow exercise at sorting out the institutional problems of the European Union, which we are doing – I think with a lot of efficiency today – at the Convention. But it should also be seen as an opportunity to think about the future of the whole of Europe and to design policies which will make the Continent a better, a safer and also a more prosperous place to live in.

Constituting Europe

Henning Christophersen*

First of all, I should say that I am very pleased at being invited to sit here among so many prominent bankers and together with President Prodi and Madame Hübner. It is a great privilege, it is a great pleasure at least for me, I don't know if it is going to be a pleasure for you, but we can wait and see.

Perhaps I should start by saying a few words about the concept of the Convention because it is an interesting and a new concept. Normally, intergovernmental conferences in the European Union have been prepared by a group of diplomats, fifteen people, one from each member state, equipped with a sign, a flag and a microphone. They have sat around a table, they have presented their own national views, sometimes relatively narrow. Agendas have emerged from these discussions, and very often it has been difficult to reach sufficiently good results; sometimes you got the impression that at the end of the process it was the principle of the lowest common denominator which had prevailed.

The Convention is a completely different body. We are not 15, we are 105 members, we are 102 alternates, we belong to our countries, the 15 plus the 13 candidate countries, but we also belong to different political constituencies; there are representatives of governments like myself and Mrs Hübner, there are representatives of national parliaments, the European Parliament and the European Commission, and we also belong to different political families. We have a Christian-Democratic conservative caucus in the Convention, we have a socialist/Social-Democratic caucus, we have a liberal one, so the Convention is for all these reasons a trans-national, a trans-ideological and trans-institutional body. Much more complicated and much more differentiated but also much more representative than the classic preparatory committee with the 15 people equipped with a flag, a microphone and a sign.

The members of the Convention are also slightly different from those who normally have been working on these matters. Some of them, some of us perhaps, are a little bit more egocentric than we should be, most of us are extremely ambitious, and if you look at the list of names of the members of the Convention you will see that nearly all the members are or have been politicians dealing with serious matters in their own

*Summary by the organizer of the Frankfurt European Banking Congress

member states and in the European Union as well. And attendance at the meetings is good, the level of participation is high, many straightforward interventions can be heard every time we meet.

I think we can now say that this concept is beginning to look like a success. That was not what everybody expected from the beginning. Many thought that it would end up as a talking shop or a place where matters were raised and discussed but where very few commitments were made, but things have changed over the last eight months.

First of all, you can see how more and more governments are beginning to be more and more active. I am chairing the group of the 28 government representatives and when I look around this circle I can now see foreign ministers from Germany, as from yesterday also from France; participating in the debate we have Mr Fini from Italy, we have many other prominent people, who really represent their governments and seem ready to make agreements, deals or compromises.

So much on the Convention. A momentum is beginning to build up. A few weeks ago, Monsieur Valéry Giscard d'Estaing presented on behalf of the Praesidium a first draft for a constitutional treaty. I think it has been well received, for many reasons: it seems to live up to the expectations presented by the Laeken Declaration, it will make the treaty more comprehensible, it will ensure the efficiency of the Union, it will at the same time simplify the whole treaty structure which for the time being is a very complex one. In many respects, the present treaty looks like a Gothic cathedral built over many many centuries with all kinds of additions added over time to reflect new developments, but so complicated that even some legal experts are unable to give us a full overview of how it works. So it is not only President Prodi who has problems.

The first fundamental proposal from the Praesidium is, therefore, to split the present treaty into two parts. To this effect we will present – and we will do this at the beginning of February – a relatively short treaty of constitutional significance containing a clear description of the common values that tie us together, our objectives, the goals we think the Union should seek to attain. Then we should describe the competencies of the Union, we should describe the legal instruments that should be available to the Union, we should describe the guiding principles for how to exercise the competencies, we should explain about the composition of the institutions, how they have to take decisions, how they have to work together, and last, but not least, we will have clear articles dealing with the rights and obligations of the member states and not least of their citizens. And here the European charter of fundamental rights will be part of to the treaty.

Then we will have four months during which we can discuss this part of the new treaty. At the same time, we are now going to prepare the second part of the treaty. Originally we thought it should have the form of a set of recommendations but a number of member states, including the Federal Republic of Germany, have now asked us in the Convention to present a fully-fledged draft treaty dealing both with the constitutional issues and all the policy issues. This will be a major task which can only be performed with the assistance of the legal services of the Commission and the Council, but we in the Praesidium are ready to make that proposal to the Convention. But it means of course we will also now have to work on all the sectoral policies and to see to which extent they should be adjusted. We need to be very disciplined because we cannot re-open everything, we cannot begin now to discuss the common agricultural policy, the British rebate, the German rebate, and so forth, but there are a number of areas where we would have to come forward with proposals. We will have to integrate what is called legal and domestic affairs in the communitarian part of the treaty. We will have to see how we can integrate the foreign and security policy provisions into the treaty itself. Perhaps we will also have to do something about Economic and Monetary Union. Some of us in this room, Herr Tietmeyer and myself, negotiated the EMU part of the Maastricht Treaty. In my view, in fact we don't need to change much. Perhaps we should ask the Commission to make the proposition as regards the broad macroeconomic guidelines. That would be helpful. But it is clear, we need a much better coordination of macroeconomic policies including much more clear determination on the port of the member states to introduce unavoidable structural adjustments. That's our main problem. We need to look at that and perhaps also that could be a part of what we are going to do with the sectoral policies.

And then we must protect the internal market and there could be a few other things.

Let me now here in conclusion mention three or four important matters I think we will have to look at. First of all, we will have to make a much clearer description in the treaty of the competencies of the Union. In fact, we do not have a chapter about that in the present treaty. You have to read the whole thing, you have to read more than 700 pages, before you can get a clear picture of the competencies of the Union. We have now proposed from the working group I have chaired that we should have a chapter in the treaty dealing with the competencies, describing what should be exclusive competence, what should be shared competencies, what should be what we call supporting measures. We also need to write into the treaty the principle of allocated powers. It means that if no power is given to the Union it belongs automatically to the member states. We need to have a good monitoring of the principle of subsidiarity, and in my view we also have to write into the treaty that when the Union has competence it must exercise that competence with due respect to the identity of the member states.

Secondly, we need simplification. We have for the time being 23 different legal instruments. That's nonsense. We don't need more than four or five. We need to simplify the decision-making procedures, as Madame Hübner rightly said. We need to simplify the execution of decisions. That should mainly be the task of the Commission. We cannot have a Union with 25 member states where 25 national representatives are looking over the shoulders of the Commission every time they have to implement a decision taken by the Council of Ministers. So simplification is another important thing.

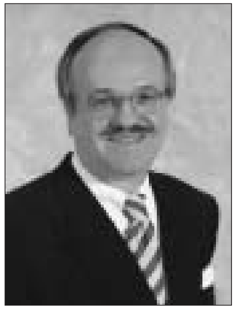
Thirdly, the institutions. There are various ideas. Some people want to upgrade the European Council, others want to upgrade the Commission, or the Parliament. To be frank about this, in my view the Convention is going to be a failure if somebody tries to change the balance between the institutions. There is only one way forward and that is to strengthen all the institutions at the same time. That should be done. The Commission should be strengthened in its executive role by handing over to the Commission the authority to implement all the decisions. The democratic legitimacy of the Commission should be strengthened. I don't believe that it is a good idea to let the European Parliament elect the President. I don't want the Commission to be the secretariat of the Council and I don't want it to be the secretariat of the Parliament. I think the only way in which we could strengthen the democratic legitimacy of Mr Prodi or his successors is perhaps to use the German model. In Germany, you have a *Wahlversammlung,* I don't know what we could call it in English, perhaps electoral college. We could ask the European Parliament together with a similar number of representatives of the national parliaments to meet and to elect the president of the Commission.

The Council itself should be strengthened. Qualified majority voting should be the norm. Only a few times should we have unanimity. Should the European Council itself have a permanent president? I have my doubts. That would create a new institution. He or she would have to build up their own bureaucracy. What should it do? Should it take initiatives? What does that mean for the role of the Commission? To whom should it be accountable – the European Parliament? I think that idea raises more questions than it gives answers. But of course this has to be discussed. But the Council itself should be strengthened. And we have to solve the problem we have now where Mr Solana and Mr Patten are travelling around the world and competing with each other, or giving at least the impression that they are competing with each other. We need a single person who can represent the Union vis-à-vis third countries.

And for the Parliament we should take the final step. The first step was taken back in 1985 when this Single Act was approved. Now we have to take the final step. The Parliament should in the future have co-legislative powers in all the areas of the competencies of the European Union. That would strengthen all the institutions at the same time.

Finally, the democratic voting of the EU. It has to be strengthened. Could the national parliaments play a role? Yes. But not by forming a new chamber but by being able to monitor what ministers are doing in the Council of Ministers in a much more efficient way. To do that you have to open up the meetings of the Council of Ministers when it acts as a legislative body. Not when we are speaking about the Americans or the Japanese and all that, but as a legislative body. That would give national parliamentarians the possibility to see how their ministers are defending their positions. And sometimes they will perhaps be very embarrassed or very surprised by what they see. And then of course the national parliaments could, as I say, play a role in the election of the president of the Commission and by exercising competence in the field of protecting subsidiarities.

Reserve Currencies: New Choices



Bernd Fahrholz

Ladies and Gentlemen,

It is a great pleasure for me to chair panel number three. "Reserve Currencies: New Choices", the title is modest, but the ambitions it conceals are not so modest: We are – of course – talking about the euro and its long-term desire to rise to international currency status on a par with the US dollar. Is this over-ambitious? Is the euro simply a new choice or could it become an alternative to the US dollar? I am convinced that during the next hour and a half we will have a very active and animated discussion about this topic.

We invited representatives of leading central banks and monetary authorities from Asia, America and Europe. Around one conference table we thus have gathered all the parties shaping the euro's emergence as an international reserve currency: the supply side (the ECB), the demand side (Asian central banks and monetary authorities), and the competition (the Fed).

I am very pleased to introduce to you a panel of individuals who are deeply involved in reserve management.

There is Donald L. Kohn, member of the Board of Governors of the Federal Reserve System. The official foreign exchange reserves of the United States are among the lowest worldwide. As the supplier of the one leading international currency the Fed just does not need to hold large amounts of reserves. That is a very comfortable position, indeed. On the other hand, supplying an international currency has difficulties of its own. Monetary aggregates become harder to interpret and control. Currency demand is more difficult to estimate. I am eagerly looking forward to Mr Kohn's comments on monetary policy under the condition of international currency status. Welcome, Mr Kohn.

Our second panellist is Mr Hng Kiang Lim, minister for health and second minister for finance of Singapore. In his function as second minister for finance, he serves concurrently as deputy chairman of the Monetary Authority of Singapore. This authority conducts the monetary policy and manages the official foreign reserves of Singapore. Representing one of the Asian countries with large reserve holdings, Mr Lim is in the rather pleasant position of being able to choose. I am very glad that you could join us today and await with great interest your reflections on the euro's chances of becoming an international reserve currency. Welcome, Mr Lim.

It is also a great pleasure to welcome Mr Tommaso Padoa-Schioppa, member of the Executive Board of the European Central Bank. Mr Padoa-Schioppa is a well-known person here in Frankfurt, his working home for more than four years. In such a small town it is inevitable that paths cross fairly often; for example, both of us have the pleasure to teach as honorary professors at Frankfurt's university. Besides, Mr Padoa-Schioppa is not only one of the guardians of the euro, but also plays a very crucial role in the integration process of Europe's financial markets. Large and integrated financial markets are a key element for an international currency. However, the ECB has no direct mandate to stimulate the use of the euro as an international currency. The primary objective of its monetary policy is to maintain price stability – which will do the most to enhance the attractiveness of the euro over time. On the foreign exchange markets, the euro is already on par with the US dollar. When will the euro be on par with the US dollar in terms of reserve currency, Mr Padoa-Schioppa?

Our panel is completed by Mr Yutaka Yamaguchi, deputy governor of the Bank of Japan. Japan has by far the largest official foreign exchange reserves in the world. At end 2001, they amounted to nearly 400 billion US dollars. If only you would shift a little more of these holdings into the euro, Mr Yamaguchi! What could convince the Bank of Japan to change its reserve management strategies? Despite Japan's recent economic woes, it remains one of the leading exporters and a major player in the world economy. From that perspective, would a greater role for the euro as an international currency benefit world trade and cross-border investments? I am looking forward to learning more about the Japanese view of the euro. Welcome, Mr Yamaguchi.

Ladies and Gentlemen,
Since the end of World War II the US dollar has been the world's more or less unchallenged international currency. Though there are good reasons for the dollar's dominance, that is nonetheless a rather strange state of affairs in a world where globalised markets are driven by ruthless competition. But at last, a competitor to the US dollar is born: the euro! Does it qualify for the competition?

My answer is: yes! The history of the euro is still brief – very brief indeed by standards of international monetary history – but there should be no doubts about the potential of the new currency. The degree of price stability is unprecedented in Europe. The euro represents an open and strong economy, and its financial markets are deep and liquid.

But even though the euro has the potential to emerge as a leading international currency, its rise to dollar-like status is by no means automatic. An international currency has a tendency to become a natural monopoly. The more transactions a currency attracts, the more liquid it becomes. Increased liquidity narrows the bid-ask spreads in the foreign exchange market; users of the international currency realise efficiency gains. In other words, there are economies of scale.

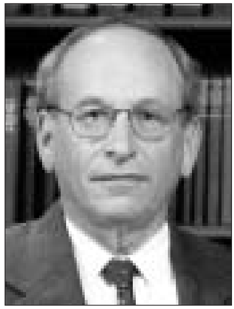
In fact, monetary history tells us that a single international currency prevailed at almost all times. Before the US dollar, the Dutch guilder in the 17th and 18th centuries and the British pound in the 19th and early 20th centuries played that role. Moreover, it always took several decades for the emerging international currency to displace the outgoing one. Even the US dollar, as the currency of the largest economy in the world since the end of the 19th century, became the dominant currency only after a long transitional period during which the British pound and the dollar were both active as international currencies.

Ladies and Gentlemen,
Without question, the euro faces an uphill battle in its bid to claim international currency status. Would it therefore not be better – and wiser – to leave things as they are? Not really. Because the competition between the euro and the dollar is not simply a beauty contest but is about hard economic facts. The international currency status offers a number of advantages: a liquidity premium for issuers of assets denominated in that currency, lower transaction costs in foreign exchange and securities markets, less hedging costs for importers and exporters and – last but not least – higher seigniorage income for the central bank. According to a recent study commissioned by the European Financial Services Round Table, the combination of all these factors could add as much as 0.4% to annual euro area GDP.

The present state of play does not reflect the euro’s and the euro area’s weight in the world economy. Official foreign exchange reserves denominated in US dollars are five times larger than reserves denominated in euro. However, the US share of world GDP is just one and a half times bigger than the euro area’s. If we look at world export shares, euro area exports actually command a higher share. Taking these figures into account, I am convinced that the euro is poised to expand its international role. The euro will gradually develop into an international currency. It only is a matter of time, is it not?

Thank you very much for your attention. I would now like to ask our panellists to start the discussion. Ladies and Gentlemen, afterwards your questions are welcome.

Reserve Currencies: New Choices



Donald L. Kohn

As a representative of the country that issues the “Old Choice“ in reserve currencies, I thought that I might use my time to address the source of the growing amount of assets denominated in that currency and held outside the United States – that is, the U.S. current account deficit. As a basis for discussion, I will put some hypotheses on the table about the origin of the deficit, its course over time, and its implications for macroeconomic policy. Before I get started, I should remind you that the views expressed here are my own and do not necessarily represent the views of other members of the Board or its staff.*

For the most part, the existing distribution of current account surpluses and deficits among the countries of the world reflects market decisions regarding the global allocation of capital. Evidently, savers around the world have anticipated greater risk-adjusted returns on their investments in the United States than in surplus countries. The upward trend in the foreign exchange value of the dollar since the mid-1990s as the deficit was climbing indicates that the rising demand for dollars from capital inflows, and not the rising supply of dollars from the trade deficit, was the dominating force in international transactions between the United States and the rest of the world.

To be sure, developments of the past few years suggest that expectations for returns on investment were not fully realized. Still, the remarkably similar asset price movements around the globe in the past two years and the relatively modest correction of the dollar imply that investors are not having major second thoughts about the relative distribution of their savings. Moreover, judging from the fact that productivity in the United States did accelerate in the latter half of the 1990s and continues to grow rapidly, the spending financed through the deficit apparently did add to real GDP growth, even though the financial returns to capital proved disappointing.

In addition, the developing configuration of current account balances has played an important role in stabilizing economies over recent years. The U.S. deficit has boosted aggregate demand outside the United States, which was especially beneficial in the mid- to late-1990s, when disruptions to capital flows and financial markets in many other countries were damping economic activity. In the United States, the availability of for-

* Michael Leahy, of the Board’s staff, contributed to the preparation of these remarks.

eign savings and foreign goods and services served as safety valves, diverting U.S. aggregate demand during the late 1990s, when it might have otherwise created inflationary pressures.

It is crucial in thinking about this deficit to keep in mind that, to the extent that it reflects an imbalance, the imbalance is shared around the world. The U.S. current account deficit is two-sided: Low saving relative to investment demand in the United States necessarily implies the reverse – a shortfall of domestic demand relative to production in the rest of the world. Therefore, any adjustment that proves necessary will also be shared around the world and will not fall solely on the United States.

It is hard to imagine that present trends in this global imbalance can continue indefinitely. U.S. assets are occupying a growing share of global portfolios. At some point, reflecting both the decline of marginal returns as resources shift toward stocks of U.S. capital and other durable assets and the inevitable flagging in the willingness of investors to place an ever-increasing share of their portfolios in dollar-denominated assets, the net flow of saving to the United States will taper off. As that happens, the level of U.S. spending on foreign goods and services will have to begin to match more closely the level of foreign spending on U.S. goods and services. U.S. and foreign asset prices, including the real exchange rate, will have to adjust to close the trade gap or, from another perspective, to bring domestic demand in the United States and elsewhere into closer alignment with domestic production.

We all need to be humble about our ability to predict when this adjustment might begin or what economic conditions might accompany it. I am sure you need no reminding of the many events in the U.S. economy and financial markets that people thought would trigger a dollar decline and current account correction, but did not. Obviously, expected returns from investments in the United States have been marked down substantially – but so, apparently, have expected returns abroad, and on a relative basis, savers seem reasonably content to continue to shift their portfolios toward U.S. investments. The rising level of foreign net investment in the United States has elevated the concern that a sudden shift in preferences away from dollar assets could be disruptive. Such a shift could be associated with large, sharp movements in exchange rates and other asset prices that might expose weaknesses in the balance sheets of some entities. Even abstracting from financial vulnerabilities, such developments in financial markets might prompt dislocations in resource usage and temporary reductions in incomes because resources are slower to adjust than asset prices.

To be sure, a disruptive correction in current accounts is a distinct risk. However, that the recent recession in the United States and the accompanying sharp drops in profits and equity valuations have not caused such a re-evaluation of relative returns is encouraging. Moreover, although resource reallocations are never frictionless, major dislocations need not result from rapid movements in asset prices. In 1985–86 the foreign exchange value of the dollar declined substantially, but the decline was not disorderly, and severe dislocations did not occur in the United States, importantly because of the mobility of labor and capital. Indeed, the currently low level of capacity utilization in our manufacturing sector means that considerable resources are available to meet increased foreign demand without putting pressure on prices.

However, even relatively smooth adjustments will present challenges to macroeconomic policies, as they did in the late 1980s. The shifting balance of domestic demand and potential supply in each country means that policies affecting domestic demand will need to be re-calibrated to preserve price stability and keep economies operating at high levels of reserve utilization. The deficit country – the United States – will need to generate more net domestic savings, perhaps through tighter government budgets, as it absorbs a greater share of global demand if it is to avoid inflation pressures and much higher real interest rates that damp investment and growth. And, as demand is trimmed in the United States, surplus countries will have to boost domestic demand to forestall a slowing in global economic growth. If the asset- and product-market adjustments are smooth or incremental, the required modifications to policy can be made gradually once adjustment seems to be under way and potential macroeconomic effects begin to be identified.

Are there steps policymakers can take even earlier – to reduce the possibility, however remote, that the adjustment will involve dislocations? Over the long-run, using fiscal policy to boost domestic saving in the deficit country might help, but such an adjustment would be counterproductive now, when the U.S. economy is operating well below its potential. Conversely, fiscal policy expansion in the surplus countries could be used to augment domestic demand, but any such adjustments would need to take account of medium-term goals for fiscal consolidation. Furthermore, fiscal policy adjustment cannot guarantee current account adjustment. For example, in the late 1990s, the fiscal stance of the United States switched from deficits to surplus, and the switch was only partly offset by declines in private savings, leaving national savings higher. Nonetheless, the current account deficit continued to grow as a result of the surge in U.S. investment and productivity and the associated capital inflows seeking the higher U.S. rates of return.

Monetary policy has an ambiguous effect on trade imbalances. Although exchange rates are notoriously difficult to predict, over time easier monetary policy relative to that abroad should prompt currency depreciation, which in turn would tend to reduce the current account deficit. However, easier monetary policy also stimulates domestic incomes, which would tend to increase the current account deficit. Simply put, monetary policy is not the appropriate tool for improving the current account. Rather, central banks have learned over the years that their policies should be devoted to fostering macroeconomic balance and price stability.

In addition, as with equity market bubbles, one is hard put to know beforehand whether large current account deficits are out of line with fundamentals, especially when those outcomes could be a result of strong productivity and high rates of return rather than of excessive spending. All told, actions to preempt a possible disruptive adjustment in asset markets and the economy are problematic in many respects.

As I have emphasized, the major reason for the growing deficit has been that the United States has been an attractive place to invest, and such investment has helped foster higher productivity and economic potential at home and a more efficient use of foreign savings. No policymaker would deliberately try to make his or her economy less attractive to reduce the discrepancies in relative returns. Monetary and fiscal policy in the United States will continue to be aimed at fostering high employment and price stability and a favorable environment for growth in productivity and incomes. Surely the best way to make perceived returns more equal around the globe would be for authorities in other countries to take whatever steps might boost expected rates of return in their domestic economies. Required actions might involve policies to improve expected cyclical performance over the next few years as well as structural reforms – to increase the flexibility, transparency, and receptiveness to risk-taking and innovation that enhance productivity and growth.

Reserve Currencies: New Choices

Hng Kiang Lim

I am very pleased to be here this afternoon to participate in this panel discussion on new investment choices for central bank reserve managers and the future trend of reserve management. This topic is especially relevant for Asian central banks because of the increasing amount of central bank reserves accumulated over the past 5 to 10 years.

Buildup of Asian Central Bank Reserves

One of the most striking developments in reserve management during the past decade has been the impressive growth in the level of total foreign exchange reserves. Specifically, among the East Asian central banks, international reserves have been growing strongly since the financial crisis in the region in 1998. The crisis-stricken Southeast Asian economies[1] have rebuilt their reserves to almost US$120bln as of July 2002. The economic recovery in Korea has also brought about growing current account surpluses and a rebuilding of its reserves to about US$115bln. Moving further north, China's reserve position has been bolstered dramatically by its strong export growth and sharp rise in foreign capital inflows. China's foreign reserves currently stand at about US$250bln, almost 75% higher than the amount in January 1998. And, Japan's consistently large current account surplus has led to a doubling of its reserves between 1998 and 2002. As a group, East Asian central banks hold about US$1.3trln of foreign reserves, or more than 50%, of the total US$2.4trln FX reserves held by central banks worldwide. Considering that the total FX reserves were only US$400bln in 1985, this rate of growth is astounding.

Concentration of Reserves in the Current Tri-polar Currency World

However, even as central banks accumulate more reserves, they have largely kept to their traditional choice of reserve currencies. Most of the reserves remain in US dollars, partly due to historical reasons, and partly because the US has the largest, deepest, and most liquid financial markets in the world.

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[1] Malaysia, Indonesia, Thailand and Philippines.

The introduction of the euro in January 1999 was touted as a challenge to the US dollar's position as the reserve currency of choice. Today, it is the second most widely used currency in the world, behind the US dollar.

With respect to the yen, whether it will gain a greater share of world reserves will depend on various factors, including the progress of Japanese banking reforms. The outlook for Japanese interest rates is also a major consideration in the allocation of reserves in yen assets.

As at end-2001, IMF data showed that 68% of world currency reserves were in US dollar, 13% in euro, 5% in Japanese yen, and the remainder in currencies like the Swiss franc and British pound. This currency composition has remained relatively unchanged over the last decade. Central banks have not ventured into new reserve currencies in a significant way.

Future Developments

Central bankers are known to be conservative. Changes are not likely to be revolutionary but incremental. I envisage three broad directions in which change will take place.

First, there will be a re-assessment of the weighting of the G3 currencies. Depending on the particular needs of each country, I believe the euro is likely to grow in importance as an international reserve currency, by virtue of the combined size of the eurozone economies and the greater volume and liquidity of euro assets.

Second, there will be a tendency to go down the credit ladder, from government bonds to agency bonds, corporate securities, mortgages, asset-backed securities and possibly even equities within the major markets.

This trend is likely to grow because in several countries, the stock of international reserves has arguably exceeded the requirements for monetary management, the funding of imports, or future foreign debt obligations. East Asia's reserve holdings, for example, have grown from 7 months' coverage of imports in 1997 to 10 months' worth of imports by the end of 2001. Relative to foreign debt, East Asia's[2] international reserves now amount to about 120% of the region's foreign debt, up from 77% in 1997. For Singapore, Taiwan, China, Japan, and, to some extent, Korea, the additional reserve accumulation represents more a pure wealth build-up objective, rather than the primary objectives of monetary management, meeting foreign debt obligations, or covering imports. There is therefore greater room and flexibility to diversify and seek out higher returns in the management of these reserves.

When a central bank has a minimal amount of reserves, it will need to keep them ready for foreign exchange intervention or foreign debt repayment. To the extent that we are still in a largely tri-polar currency world, it will reasonably invest its reserves in safe and liquid G3 government securities. But when it has accumulated reserves beyond that minimum threshold, it can arguably afford to go beyond the traditional boundaries of the safe and liquid G3 government securities, into higher risk and less liquid assets to seek better returns.

[2] Excluding Japan.

The economic argument for considering non-sovereign assets is compelling. As different assets perform best at different stages of the business cycle, diversifying amongst several asset-types of the same currency creates a more balanced portfolio with better long-term returns.

Third, there will be a gradual diversification into new currencies, reflecting the economic and trade relationships of individual countries. For East Asian central banks, how significant would development along this third direction be?

There are two parameters. The first is the choice of the new currency. There are pre-requisites that a currency should meet before it can attract reserves investments. Free convertibility of the currency is one. Also, a transparent and efficient market, and a sound legal regime. The second is to have a diverse range of assets that can meet the investment criteria of the central banks.

In this regard, let me now take a few minutes to talk about how Asian markets in general, and Singapore in particular, have progressed in recent years.

Developments of Asian bond markets

Asian financial markets have historically been dominated by equities. However, many governments in Asia have made significant efforts to develop their domestic bond markets over the years since the watershed event of the Asian financial crisis. They have put in place measures to develop a liquid government benchmark yield curve, and made infrastructure upgrades to facilitate investment and secondary market activity.

Indeed, many of Asia's domestic debt markets have witnessed impressive growth, both in depth and liquidity. Both North Asia and Southeast Asia have experienced a doubling of corporate bond issuance since the trough of 1998. The volume of corporate issuance for the first three quarters of this year has already surpassed the amount for the whole of 2001.

The range of products has also grown. Asset-backed securities, mortgages, REITS are some of the new products being introduced. With this, banks and exchanges have also launched new derivatives to manage these risks. The growth of Asian domestic bond markets have led to the recent establishment of various Asian USD and local currency bond indices to track the performance of these domestic markets. Asian countries have set in place the necessary infrastructure to develop the bond markets. The continuing challenge would be to widen the investor base in Asia to help sustain and deepen regional bond markets.

To entice investors into these markets and inspire greater investor confidence, three key pre-requisites need to be met. Firstly, we need to develop a wide range of investible assets. Development of market infrastructure should not stop at vanilla products. The provision of a wide range of financial instruments, which include derivative swaps, options and asset-backed securities, would allow market participants to better isolate, choose and manage their risk exposures.

Second, Asian debt markets need to move towards a regime for stronger corporate governance and disclosure. Higher disclosure of international equivalent standards and greater transparency will clearly allow foreign investors to better differentiate and assess the quality and safety of their investments, and generate investor confidence. Thirdly, establishing an efficient and transparent market mechanism for price discovery is important to help reduce the spread between bond prices and enhance liquidity.

Over the past few years, Singapore has taken measures to build the liquidity and depth of the domestic bond market. For example, we have extended the benchmark yield curve to 15-year issues, and adopted an issuance programme that focused on building large liquid benchmarks. Our efforts have culminated in SGS being included in reputable international bond indices such as the JP Morgan Government Bond Index Broad, as well as the Lehman Brothers Asian-Pacific Aggregate Index. The S$ corporate bond market has also grown tremendously. Many foreign issuers, including IFC, the EBRD and US corporations like Freddie Mac and GE, have tapped our market.

In the last four years, we have also liberalised the policy of non-internationalising the S$. The S$ policy in its existing form does not impede capital market developments. As a result, we have seen greater foreign participation through issuance or investment in Singapore's capital markets, which has improved the market's depth and liquidity.

Conclusion

To conclude, we are at the threshold of a significant transformation in reserve management of central banks, from the traditional "liquidity first" focus to a more balanced objective that includes total return maximisation and risk diversification considerations. East Asian central banks now have far greater choices, not only in the re-calibration of the weighting in G3 currencies but also to move beyond the exclusive reliance on government bonds in their reserve portfolio to corporate bonds. With the progress made by Asian governments in developing their respective debt markets, Asian bonds, both sovereign and corporate, also present themselves as "new choices" for reserve currencies.

Reserve Currencies: New Choices

Tommaso Padoa-Schioppa

Ladies and Gentlemen,

It is a pleasure to share with you today some thoughts on the role of the euro as an international reserve currency. The euro has given further monetary, financial, and economic cohesiveness, as well as a stronger identity and visibility, to an economic area which had been shaped into a single market over a period of many decades. My intention today is to discuss to what extent the euro has also created new opportunities outside the euro area, for both authorities and market players.

Three questions might help to address this issue. Does the euro offer new choices for diversification of foreign reserves to authorities outside the euro area? Has the euro opened up new opportunities for the design and the conduct of exchange rate policies in third countries, in particular in regions neighbouring the euro area? Has the existence of the euro changed the global monetary system, and in what sense?

I will address these questions in four steps. First, I will look at the international private use of the euro. Second, I will focus on its official role as reserve currency amid global developments in the currency diversification of foreign reserves. Third, I will consider the use of the euro in the regions geographically close to the euro area. Finally, I will enlarge the picture and consider the global monetary and financial system.

We should be aware that assessing the international status of a currency is particularly difficult, and the euro is no exception. Indeed, no comprehensive set of harmonised international statistics exists to measure how leading currencies are used outside their jurisdictions. Thus, in spite of the significant efforts made by the ECB – which takes the form of a yearly Review on the International Role of the Euro – evidence is often partial or confidential and any assessment always requires caution. Please keep these important caveats in mind in the course of my presentation.

I. The private use

As an international currency, the euro, like any other currency, has multiple uses, which are related to the three well-known functions of money as a store of value, medium of exchange, and numéraire. One is the issuance and the placement of euro-denominated debt securities outside the euro area. Another is its role in foreign exchange markets. A third is its use as an invoicing currency in international trade. Finally, the euro can be adopted as a parallel currency in third countries. I shall briefly review these four uses in turn.

The store of value function is the one area in which things seem to have moved fastest. The market segment in which the use of the euro has been increased most strongly compared with pre-euro currencies (what we call the legacy role) is the issuance of debt securities. Considering all outstanding bonds and money market instruments, including the domestic markets of the United States, Europe and Japan, the euro today accounts for one-quarter of the global market. If domestic markets are excluded, the euro's share increases further, to slightly below 30%. This is a market share of around 10 percentage points higher than that of the legacy currencies.

It is interesting to note that the bulk of these debt securities do not originate from third country governments or international institutions, but from multinational industrial corporations and mortgage agencies. The euro is used for liability diversification by first-class private addresses, most of them located in industrial countries (in particular the United States and the United Kingdom).

We have analysed the features of these bonds at the ECB. We have come to the view that the non-euro area borrowers expect to place such bonds mainly with wholesale and retail investors within the euro area. Indeed, available data on the currency breakdown of the international investment position of some countries of the euro area indicate that euro-denominated bonds represent a predominant portion of securities bought by residents. In other words, foreigners issue euro-denominated bonds, and euro area residents buy most of them.

Outside the euro area, the demand for euro-denominated securities is concentrated in London and other European financial centres. Surveys conducted by private financial companies confirm that the euro has a negligible share in funds managed in the United States and Canada, while it represents one-third of funds managed in European countries outside the euro area and the EU.

In the foreign exchange market, the euro-US dollar currency pair is the most liquid market segment in spot markets, with a daily turnover of EUR 150 billion on average. In general, as documented in the latest Triennial Central Bank Survey of the Bank for International Settlements on "Foreign Exchange and Derivatives Markets Activity", the overall size of foreign exchange markets has experienced a 20% contraction, mainly due to the impact of new technologies and to market concentration. In addition, the share of the euro in spot and swap markets – considering all currency pairs involving the euro (USD/EUR, JPY/EUR, GBP/EUR, CHF/EUR, etc.) – is lower than that of the legacy currencies (1998).

Turning to numéraire and medium of exchange functions, we should note that for trade invoicing no accurate statistical evidence exists on the past and present international use of currencies in the euro area. However, data available for some euro area countries suggest an order of magnitude of 40–50% for the share of imports and exports invoiced in euro, a share that has increased in the last two years (the only ones for which data exist). This is a field subject to a significant structural component, since energy and other commodities, representing 20% of total imports of the euro area, are most unlikely to change the currency (the US dollar) in which they are priced.

Finally, encompassing all the three monetary functions, the euro is also used as a parallel currency, mainly in Central Europe, in the Balkans, and around the Mediterranean. According to our estimates, the euro system shipped around 8% of the total amount of euro currency in circulation (in net terms, including back flows) to destinations outside the euro area between December 2001 and end-June 2002. This amount is only a proxy of euro banknotes circulating abroad, as it does not include transfers directly made by tourists, migrants, etc.

Let me summarise. The euro is an important currency for the denomination of debt securities in the world. The US dollar-euro currency pair is the most heavily traded worldwide. An important and increasing portion of euro area trade is priced in euro. The euro is used in third countries as a parallel currency. Taken together, these facts and figures suggest that overall, in its early years, the euro has somewhat enhanced its international role, and that it has done so in an uneven manner. We should not forget that, unlike the domestic role of a currency, which is heavily determined by institutions, – the international role of a currency is almost entirely use-driven and can proceed at different speeds for the different monetary functions.

II. The official use

I now turn to the official use of the euro and focus on its role as an international reserve currency.

Data published by the International Monetary Fund indicate that around 13% of global foreign exchange reserves were held in euro at end-2001. The corresponding share for the US dollar was 68%; for the Japanese yen the share was 5%. Considering developments in the past, the percentage for the euro is similar to those recorded in 1999 and 2000 and, adjusting the data to take account of the start of EMU, also to the combined share of legacy currencies.

Interpreting the data is not easy. Other sources (including public data on reserves' currency breakdown for some, admittedly few, countries) point to developments that do not convey the same sense of immobility. Authorities in countries like China, South Korea, Pakistan and Russia have recently made statements on increasing the share of euro in their official reserves.

Despite these caveats, I rely on the main conclusion suggested by official data: the share of the euro in global reserves has remained stable and much lower than that of the US dollar. I am not surprised by this, and I can outline some reasons for this, referring to the most recent developments in the diversification of foreign reserve currencies.

An important element is the trend which preceded Economic and Monetary Union. In the ten years before the advent of the euro, the share of the US dollar in global reserves had increased by twenty percentage points. This constant interest of central banks in accumulating foreign reserves in US dollars during the 1990s is a remarkable development. The recent economic literature has helped to understand it by highlight-ing some stylised facts. I will review the factors triggering US dollar holdings for each of the four reasons given in the literature for holding reserves: transaction, intervention, investment and precautionary needs.

Firstly, reserves may be held for transaction needs, i.e. to finance imports and repay external debt. In this case, authorities tend to match the currency composition of reserves with the currency denomination of their imports and financial liabilities. As the US has been the most dynamic economic region in the last decade, the rest of the world has expanded trade and financial transactions with it. Consequently, the need to hold US dollar reserves has increased correspondingly.

Secondly, reserves may be used to carry out foreign exchange interventions. In this case, authorities orient themselves towards the currency to which they peg their exchange rate. In this respect, the US dollar is not only the reference international currency for some of the largest reserve holders (China, Taiwan and Hong Kong), but also a vehicle currency which may be universally used to transact in almost all currency pairs in the world. Moreover, many countries continue to manage the exchange rate against the US dollar, and need US foreign reserves for this purpose, even after they have discontinued formal pegs to the US dollar (so-called "fear of floating").

Thirdly, reserves are an instrument for authorities to store value and to yield a return on investment. To this end, authorities follow a portfolio approach and try to optimise their risk-return combination. Currency diversification of the portfolio is part of this strategy. But one important technical factor limiting the scope for diversification is the need to measure the return of a portfolio in one numéraire currency. Risk-averse central banks tend to favour the US dollar as their numéraire currency, and therefore attribute a large share of their foreign reserves to the US dollar to protect the ex-post return of their portfolio from fluctuations due to exchange rate volatility.

Finally, authorities may hold reserves for precautionary reasons, for example, to respond to exceptional events (wars, embargoes, banking crises) and to deter possible speculative attacks against the country's currency. Several authors find evidence that, with spreading capital liberalisation, authorities have become more risk-averse and have altered the currency composition in favour of the US dollar, as the US hosts the deepest and most liquid financial markets.

That said, I am aware that, besides these elements of inertia, there certainly exist factors susceptible to stimulating currency diversification, even if they have not been reflected in available IMF data yet. I should like to briefly mention three of them. First, exchange rate developments. While the initial depreciation of the euro against the US dollar may have restricted the use of the euro as a reserve currency, in 2001 and even more markedly this year market trends have favoured diversification towards the euro. Second, the implementation of the "Financial Services Action Plan", which aims at creating the legal framework for a more integrated and liquid internal market for borrowers and investors in the European Union, is making progress. Third, countries like South Korea or Russia, which had concentrated their official reserve policy on the dollar to create a very strong safety net against potential speculative attacks, have by now largely reached this objective, and hence regained room for diversification.

In conclusion, available official data suggest that, of all the international uses of the euro, its role as a reserve currency is the least developed, both compared with its legacy currencies and with the US dollar. This may be the result of the marked increase in the US dollar's share in total reserves during the 1990s, a trend due to several concurring factors. Since 1999, the share of the US dollar has stabilised, but it is very difficult to assess whether there is a causal link with the introduction of the euro. Occasional evidence on authorities' interest in increasing their euro share is not yet reflected in official IMF data.

III. The euro in its neighbouring region

Let me now consider the role the euro plays in its neighbouring region. This comprises a group of countries near the euro area, namely the three EU Member States outside the euro area, other industrialised European economies, Central and Eastern Europe, the Balkans, Russia and the countries around the Mediterranean.

For the countries in this broad region, the euro is generally the reference currency. The regional role of the euro is implicit in several features of the euro markets, some of which I have already mentioned. Allow me to recall them in brief.

First, outside the euro area, capital markets in euro have developed mainly in London, where they represent a major share of turnover, but not in other financial centres, such as New York, Tokyo, Singapore or Hong Kong. Second, non euro-area issuers have mostly targeted European investors when placing euro-denominated bonds; however, the same issuers have targeted global investors when issuing securities in the US dollar (i.e. not only in Europe, but also in the Americas and Asia). Third, the euro circulates as a parallel currency in Central and South-Eastern Europe, in the Balkans, and around the Mediterranean.

This regional role is in line with so-called gravity models, which use geography as an explanatory factor in economic developments. The most recent literature has extended gravity models from trade transactions – the field where this theory was first developed – to financial services. Also for them, "distance has not died", although financial markets are certainly connected with global networks.

The regional role of the euro is also consistent with trade and financial links between the euro area and surrounding countries, links which have significantly tightened over the last years. For example, the euro area absorbs on average 60% of the exports and provides around 50% of the imports of the EU accession countries. Moreover, euro-area credit institutions own an overwhelming portion of the banking sector in Central Europe and in the Balkans, exhibiting a degree of cross-industry integration which has not yet been reached even in the euro area itself. In Russia, which remains linked to the US dollar, 85% of international bank claims originate from credit institutions of the euro area.

Countries bordering the euro area frequently use the euro also as external anchor for monetary policy. This is mainly the case in Central and South-Eastern Europe, where four countries have adopted a currency board implying a peg to the euro (Bosnia and Herzegovina, Bulgaria, Estonia and Lithuania) and two others unilaterally shadow the ERM II (Hungary and Cyprus). In this same area, several other countries tightly manage their exchange rate to the euro. This is the case for Romania, Slovakia and Slovenia, among the candidate countries; for Croatia, FYR Macedonia and FR Yugoslavia in the Balkans. In North Africa, Morocco and Tunisia have given a prominent share to the euro in their reference currency basket.

It is noteworthy that many countries near the EU do not intend to abandon adjustable pegs in favour of either free floats or "super-hard". I regard this positive attitude towards "intermediate regimes" as probably justified for small open economies in highly integrated regions around Europe. It may indeed make sense, in their case, to give appropriate consideration to the exchange rate in the design of economic and monetary policies.

Decisions to use the euro as an anchor for domestic policies are taken unilaterally by the authorities of third countries, without any involvement or commitment by the ECB. In the specific case of EU accession countries, however, these relations potentially entail a monetary dimension for the ECB. Once in the European Union, these countries are expected to join the ERM II, to fix an official parity to the euro, and ultimately to join the euro area, upon compliance with the convergence criteria. Also in expectation of these developments, the ECB is increasingly involved in a policy dialogue with the accession country central banks.

IV. The euro and the global monetary and financial system

Do the reflections on the euro in its neighbouring region mean that the introduction of the euro in January 1999 has modified crucial aspects of the global monetary system? My answer is: it has not, at least for the time being. Most aspects of the international monetary system have remained unchanged. The so-called "international financial architecture" itself, i.e. the set-up of institutions and rules for international monetary co-operation, has experienced only incremental changes. Let me thus, in my concluding thoughts, enlarge my framework of reference to take in the global monetary system.

The exchange rate relations between the three major international currencies continue to be characterised by large fluctuations under the prevailing floating regime. Exchange rate movements of the euro vis-à-vis the dollar and the yen have been broadly the same as those of the Deutsche Mark against the US dollar and the yen in the last three decades. Cyclical and structural differences between the three major economic areas and the current level of co-operation warrant flexible exchange rate relations between the three major currencies. Moreover, foreign exchange markets – while having contracted in size, owing mainly to technology and banking concentration – have such a large turnover (around EUR 1,200 billion per day) that it is difficult to consider how relations between leading currencies might be organised otherwise.

Prior to the start of EMU, academics discussed at great length whether the new tripolar world would be more or less suited to international monetary co-operation. Several years have now passed and, in many respects, the jury is still out. The US, the euro area and Japan together represent more than 60% of the world economy in GDP terms. Especially in international financial markets, developments in any of the three areas tend to generate spillover effects in the other ones, as well as in the global economy. Nevertheless, the very large dimensions of the three major economies, and their limited openness in terms of external trade to GDP, justify their focus on the crucial domestic challenges confronting them. All in all, the readiness of policy-makers in the three major economies to step up co-ordination of their policies has not changed markedly since 1999.

Conclusions

Ladies and Gentlemen,

At the beginning of my presentation, I asked three questions: Does the euro offer new choices for the diversification of foreign reserves to authorities outside the euro area? Has the euro opened up new opportunities for the design and the conduct of exchange rate policies in third countries, in particular in regions neighbouring the euro area? Has the existence of the euro changed the global monetary system, and in what sense?

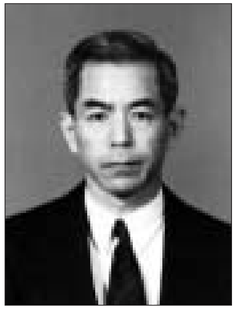
The answer to the three questions can be summarised in a few lines. First, while the euro's international role has been developing in many respects, its role as an international reserve currency has remained subdued. Second, the use of the euro as an anchor for third country monetary policies is concentrated in financial centres and regions close to the euro area, in line with the strong trade and financial links between Europe and these regions. Third, the creation of the euro has not per se modified the fundamental features of the international monetary and financial system, which continues to be based on floating exchange rate regimes for the three major international currencies.

You may wonder what are the immediate policy implications for the ECB. In reality, the world's major central banks know that their policy decisions have, at least in the short term, a limited impact on the international role of currencies. For the Federal Reserve, the international role of the dollar is largely an exogenous element. The dominant position of this currency in world markets basically reflects the size and strength of the US economy. It is also deeply rooted in the geopolitical role of the United States – including the dominant role which the US dollar played in the Bretton Woods system at the time of economic reconstruction after World War II – and is presently reinforced by network externality effects.

Also for the ECB, both the increase in the international role of the euro in some market segments (mainly debt securities) and the stagnation of the euro's share in international world reserves are largely exogenous factors. They are the direct consequences of decisions taken by private and public institutions outside the euro area. These decisions are made in a complex international environment which includes many factors, such as the strength of the euro, the vigour of the euro area economy, its relative weight compared with other economies and the overall role of Europe on the international scene. The role of the ECB is to ensure that the euro is, and remains, a stable and non-inflationary currency.

Reserve Currencies: New Choices

Yutaka Yamaguchi



I appreciate this opportunity to address the distinguished audience and thank the organizers for giving me this privilege.

I suspect that twenty years ago the European Banking Congress would not have chosen the topic for today, because the German authorities, and to a lesser extent the Japanese authorities too, were known for their reluctance to accept a greater international role of the DM or the Japanese yen. We have come a long way from the less globalized and less integrated capital markets to consider new choices for reserve currencies. Mr. Chairman, allow me to talk in the following on a little bit wider concept of international currency rather than on "reserve" currency narrowly defined.

There are two considerations as to whether there is any alternative to the US dollar as the dominant reserve currency. One is whether an alternative is necessary, and the other is whether such an alternative has any prospects of success.

The first question of whether an alternative is necessary at all could be rephrased as whether the recent situation, where the role of the US dollar as a reserve currency has been increasing again, is deemed desirable or not.

Accepting that the international status of the US dollar is basically a reflection of the strength of the US economy and of the overwhelming depth and convenience of its financial markets, I still think that it would be desirable for the dollar to hold less than a monopolistic position as an international currency. This is because I believe that competition among major currencies would serve the interests of the world economic developments. Such an environment would promote not merely sound management of macroeconomic policies in major countries; it would also help enhance efficiency of major competing financial markets. Admittedly the existence of multiple international currencies might pose a risk of evoking instability in international financial markets due to rapid currency substitution. However, such a possibility would further discipline monetary policies of key currency countries.

This leads me to the second consideration: are there any prospects for an alternative to the US dollar as a dominant reserve currency? Arguably the most promising would be the euro. But since Tommaso Padoa-Schioppa has made an elaborate presentation on the euro, I don't see any need to add comments with respect to its dazzling future.

What about the prospects for other currencies, for instance the Japanese yen which is a distant third runner accounting for 5% of international reserves?

A more extensive use of the yen has often been a topic for discussion in Japan in the last twenty years or so. It sometimes constituted a part of major financial reform agenda. In such discussions, "internationalization" of the yen has been deemed beneficial for East Asian countries based on the following line of thinking: while East Asian countries are highly dollar-dependent, the yen-dollar rate has often fluctuated widely, trade volume with the US not necessarily outstanding, counterpart countries of direct investment fairly diversified, and consequently, it would be desirable to have the yen more widely used in the region. In practice, little progress has been made towards that direction.

In contrast to Europe where a strong political will for economic and currency unification has existed, no such orientation has been witnessed in the Asian region so far. This is no surprise given the diversity in the stages of economic development there. For the yen to be better used in the region, its attractiveness needs to be enhanced from a purely economic rationale.

In this context, it is obvious that Japan has to put its house in order. This should include improved macroeconomic performance, a stronger financial system and a creditable fiscal consolidation plan. In addition, the efficiency and usability of the Tokyo financial market have to be further upgraded. But the point I want to make here is as follows: even if these conditions were met, making the yen's use more convenient, they would not be sufficient to induce diversification from the US dollar. A major hurdle here is the "network externality" occasioned by the existence of already developed financial markets denominated in the US dollar. The strength of the "network externality" is that market participants are so accustomed to using the US dollar that they wouldn't even think of using other currencies. Thus the strongest of Japan's exporters are often caught off guard when asked why they don't shift to yen-denominated trade to avoid exchange rate risk. There might be little incentive to willingly convert transactions from the dollar to the yen even if the yen has somewhat increased in convenience. It is extremely difficult to break in on a virtuous circle stemming from such inertia where the wide use of the US dollar increases the depth of the market, only further enhancing convenience of the dollar.

History suggests that the dollar's international network was the product not merely of the strength of the US economy and the deep and liquid NY market; it was established through years of activities by US multilateral firms and international banks. Their managerial resources and financial services appear to have worked instrumental to formulate the global network to use the dollar. In contrast, Japan's direct investment in East Asia in the post-Plaza Accord years, vast as it was, did not bear fruits in terms of formulating the yen's network. This deserves a careful study.

In the light of network externality in favor of the US dollar, candidates for reserve currencies should be prepared to patiently build a robust system of financial services with long-term perspective involving "decades" time frames, rather than "years". Progress toward such a direction may not necessarily lead to a global or regional network for greater use of the currency in question. It would nonetheless be desirable from the domestic standpoint alone and appears worth pursuing.

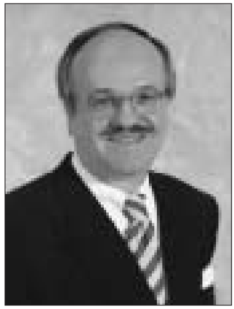
The first useful step could be to induce larger foreign investment into non-dollar denominated assets. In this context, Germany in the 1990s presents an interesting example. With reunification, the budget deficit grew rapidly. As the debt expanded, a significantly larger portion was acquired by non-residents. Indeed at the end of the decade, foreigners' share in public debt outstanding rose to 36%, up from 21% in 1990. Among others, deliberate efforts by German authorities to make the debt instruments more attractive appear to have played a key role in the changing composition of public debt. Needless to say one cannot overlook the saving-investment gap to analyze the transformation of debt structure. Nonetheless, this German episode is an illustration of what could be helpful to promote the international use of a currency, as the store of value in this case.

My final point today is the possible effects on the choice of currency of innovation in information technology. In the development of information technology, economies of scale and network externality matter a great deal. As borderless transactions in goods and financial services expand worldwide exploiting technologies such as the Internet, the advantage in holding a currency which is convenient to use for such occasions might rapidly increase.

In addition, innovation in information technology could rapidly accelerate currency substitution, a phenomenon where a foreign currency is used for payments and settlements in lieu of a domestic currency. Such currency substitution or dollarization has historically emerged as the result of the voluntary choice of the private sector when central banks lost their credibility. The case I am raising as a potential is different in nature. It would be the case where technology allows a rapid improvement in access to deposits one day triggering a shift of a substantial portion of domestic payments and settlements to foreign currencies, which could lead to a hollowing out even in the absence of severe domestic problems such as hyperinflation. If such a development progressed and dollarization and eurorization were to be widely seen, it would certainly affect the selection of the reserve currency.

Thank you for your attention.

Reserve Currencies: New Choices



Bernd Fahrholz

Ladies and Gentlemen,

Even when discussing long-term developments reaching far into the future we should not allow ourselves to feel too remote from the present. My present duty is now to close our panel. Time is always too short, but we used the time available extremely efficiently and gained some highly pertinent first-hand information on reserve management strategies of central banks. I would like to thank all panellists for sharing with us their perception of "Reserve Currencies: New Choices". Thank you very much!

An international currency is not made by decree, but by the myriad of private decisions on which currency to use. It is the operation of market forces that will ultimately define the international status of any currency.

However, saying it is the market that determines the euro's fate does not mean that a "wait and see" strategy will be sufficient. On the contrary, we should do our utmost to improve the market environment, ensuring that the market outcome will be in our own interest. What we Europeans have to do is to "persuade" all kinds of investors to hold more euro-denominated assets. How can we do that? The critical factor is the relative rate of return. It depends upon the capabilities of firms to generate decent profits and upon the economy as a whole to accelerate productivity growth.

Therefore, Europe must deliver: We have to complete the integration of financial markets and we have to press harder for economic reforms. If we succeed in creating a European economy that is as competitive as the US economy, then, in time, the international role of the euro will match that of the dollar. But the question remains: can Europe deliver? Here in Frankfurt, I should ask more precisely: can Germany deliver? And *will* Germany deliver?

I hold some strong views on this question, but strong views need time for elaboration. Another panel or even another conference would be necessary. Let me just say that neither the handling of the EU-enlargement process with the intractable issue of agricultural policy reform nor the programme of the newly re-elected German government do exactly excite my enthusiasm when it comes to delivery. Short answer nevertheless: I am still convinced that Europe and Germany can and will move towards implementing necessary – and eventually unavoidable – reforms. Otherwise, if Europe is unable to overcome its propensity for postponing reforms, hopes of the euro becoming a leading international currency will be dashed.

Ladies and Gentlemen,
Thank you very much for your attention. I hope you profited from this third and last panel as much as I did. And now, I leave the floor to Mr Müller, chairman of this year's Frankfurt European Banking Congress, for his closing remarks.

Closing Remarks

Klaus-Peter Müller

Ladies and Gentlemen,

In about five minutes, this year's Frankfurt European Banking Congress will be coming to a close. Once again, it has certainly been a marathon – an entire day of fascinating but demanding presentations, from my point of view certainly highlighted by the two presidents in attendance today and by the very active participation of the panellists. There is some premium around the corner now in the form of our traditional "Happy Hour", at which I'm sure we will continue our exchange of views in a certainly more relaxed atmosphere.

But before we do so, I want to thank all of our panellists on behalf of all those participating and also on behalf of my two colleagues, Josef Ackermann and Bernd Fahrholz. The panellists' contributions are, of course, absolutely essential to the success of any congress. At the same time, I also wish to thank all those – in front of and behind the scenes – whose efforts have ensured that this event could run so smoothly, from our chief economists, to Nader Maleki and our lovely ladies in red. You may clap now.

To round off today's congress, let me briefly try to highlight three important aspects.

Of the topic of the first panel "Exchanges Take Stock", the integration of the EU securities markets is a good example of all the difficulties of creating a well-functioning single market. The seminal work of the group of experts, actually a group of wise men, led by Baron Lamfalussy, clearly illustrated the conflict between efficiency in decision-making, on the one hand, and the democratic procedures, on the other. In other words, is comitology the right answer, can such an approach ever by applied to core questions such as Basle II?

At the second panel "Constituting Europe", I think we are well-advised to follow President Rau's sober views on the future of the European Union, in particular on the statement that there will be no United States of Europe, not even in the long run. But I greatly welcome the overwhelmingly positive attitude towards eastern enlargement.

Finally on panel III on "Reserve Currencies", the euro is certainly lagging behind its potential as a reserve and investment currency, as Professor Padoa-Schioppa has indicated to us today. And although I share all the hopes for a larger role for the euro in the future, I cannot avoid the impression that it is primarily the assessment of global investors with regard to the dollar which will determine the future role of our currency.

But I don't want to outstay my welcome here. No doubt, you're all looking forward to the Happy Hour.

I hope you have found today's event as enjoyable and rewarding as I have. If so, I'm sure you will immediately make a note of next year's event on the last Friday but one in November – that is: November 21st. We look forward to seeing you again on that occasion. The 2003 Frankfurt European Banking Congress meeting will be chaired by Josef Ackermann.

I would be very pleased now if you could stay for the Happy Hour. Have a safe trip home.

Thank you and *Auf Wiedersehen.*