Identify Europe

13th Frankfurt European Banking Congress · 2003

Identify Europe

13th Frankfurt European Banking Congress
November 21, 2003

Contents

Dinner Speech at Schlosshotel Kronberg, November 20, 2003

EUROPE AT THE CROSSROADS

Jean-Claude Trichet
President, European Central Bank, Frankfurt am Main ....

Frankfurt European Banking Congress, November 21, 2003

IDENTIFY EUROPE
Welcome Address

Petra Roth
Mayor, City of Frankfurt am Main ....

Introduction: Josef Ackermann
Chairman of this year's Frankfurt European Banking Congress,
Spokesman of the Board of Managing Directors, Chairman of the
Group Executive Committee, Deutsche Bank, Frankfurt am Main ....

I. CONSTITUTE EUROPE

Panel Chairman: Josef Ackermann
Spokesman of the Board of Managing Directors, Chairman of the
Group Executive Committee, Deutsche Bank, Frankfurt am Main

Gianfranco Fini
Deputy Prime Minister, Republic of Italy, Rome, Italian Government
Representative, EU Convention, Brussels ....

Csaba Lázsló
Minister of Finance, Republic of Hungary, Budapest ....

II. STRATEGIC OPTIONS IN BANKING

Panel Chairman: Josef Ackermann
Spokesman of the Board of Managing Directors, Chairman of the
Group Executive Committee, Deutsche Bank, Frankfurt am Main ....

Hans-Paul Bürkner
Senior Vice President, The Boston Consulting Group, Frankfurt am Main ....

Karl-Heinz Floether
Group Chief Executive, Accenture, Kronberg/Ts. ....

Hans-Jörg Rudloff
Chairman, Barclays Capital, London ....

Martin Blessing
Member of the Board of Managing Directors,
Commerzbank, Frankfurt am Main ....

Horst Müller
Member of the Board of Managing Directors,
Allianz/Dresdner Bank, Frankfurt am Main ....

III. EURO EXTENSION

Panel Chairman: Klaus-Peter Müller
Chairman, Commerzbank, Frankfurt am Main ....

Lars Heikensten
Governor and Chairman of the Executive Board, Sveriges Riksbank, Stockholm ...

Jean-Pierre Roth
Chairman of the Governing Board, Swiss National Bank, Zurich ....

Jean-Claude Trichet
President, European Central Bank, Frankfurt am Main ....

Zdeněk Tůma
Governor, Czech National Bank, Prague ....

REFORMING EUROPE

Ernst Welteke, President, Deutsche Bundesbank, Frankfurt am Main ....

Europe at the Crossroads

Jean-Claude Trichet

Ladies and Gentlemen,

It is a great pleasure to speak to you tonight. This is a special occasion for me. It is the first time that I address - as President of the European Central Bank – the European banking community. As European bankers, you are of great importance for our work at the ECB and – if I may say so – the ECB is of relevance for your work. It is good to be here tonight with you and it is nice to see many familiar faces and good friends. Thank you very much for the invitation.

I am particularly grateful that this dinner takes place so close to my new home, Frankfurt. Please let me, in the presence of the Mayor, Mrs Petra Roth, express my gratitude and admiration to this city. As Member of the ECB's Governing Council and previously of the EMI Council, I have been coming to Frankfurt regularly over the last nine years. By and by this city has become dear to me. It is a pleasure to see to what extent Frankfurt accommodates its banking community. The city provides us with the amenities and attractions of a truly modern and international life.

„Identify Europe“ is the title of the congress that provides the occasion for our dinner tonight. It is a title which reminds me of essays that I had to write at school, such as „Characterise the Renaissance“ or „Explain the Rise of the Roman Empire“. „Identify Europe“ comes as an imperative – almost an order. It urges us to define what Europe is about. There are, of course, many ways of approaching this question. We can define Europe geographically, culturally, historically or economically.

Please allow me to reflect upon the issue from an institutional perspective. As President of the European Central Bank, I will interpret the term Europe as the European Union. Thus, I will take the title of the congress as an encouragement to discuss the EU's main characteristics.

I think it is the right time to reflect upon the key features of the EU. Europe stands at the crossroads. It needs to take the right decisions now in order to maintain its major qualities in the coming years. What are the main tasks facing the EU? First, the Union needs to give itself an institutional foundation – a solid Constitution - that makes the EU fit for the future. Second, the Union has to integrate an unprecedented number of new Member States.

In my speech, I will concentrate on these two tasks and discuss to what extent – from the perspective of a central banker - the EU is on the right track. I will, however, start by identifying what I regard as the three key qualities of the European Union.

Three key qualities of the European Union

The European Union is a remarkable endeavour which is absolutely unique in human history. Three reasons are, most of the time, proposed for explaining this collective will of the Europeans to unite. First, the lessons drawn from the wars, particularly the last two world wars, which were, from a European standpoint, abominable civil wars. Second, after World War II the emergence of the Soviet Union empire creating a major economic, social and strategic threat for Europe. And third, the challenge of global economic competition which called upon the setting up of a large single market to benefit from economies of scale of the same order of magnitude as those existing in the US single market.

Ensure peace amongst the Europeans, protect Europe against external threats, permit Europe to cope efficiently with global competition had undoubtedly played a role in the bold European adventure of the last half century. But I am not sure that they are really telling the full story. In a way all these reasons are defensive, aiming at protecting Europe against domestic and external dangers. I trust that at the heart of the European ideal of today there are also ideas that are profoundly enshrined in the European psyche: the idea of universality which is topical in the „Enlightenment“, in der „Aufklärung“, dans les „Lumières“. In this perspective, European Union „in motion“ would be also driven by this profound and rich European dedication to universality which is at the root of our civilisation and the ultimate goal of the Europeans. I am referring to fertile ideas of ancient times. But as Jean Monnet said in his „Mémoires“: „There is no such thing as premature ideas, there are only ripe times that one should wait for.“

Whatever the complex set of reasons, almost fifty years ago European nation states took a bold step: they decided to work together. They initiated a European project which over time transformed this continent. I have always seen the European Union as an impressive sailing ship with strong masts and many sails. This sailing ship and its crew have three very important qualities: clear objectives, willingness to co-operate, and openness to „newcomers“.

- From the beginning, Europe has been set on a clear course and sailed with a clear mission. This is to achieve prosperity, peace, and stability for the citizens of Europe.
- Member States work together as a team. They are willing to pool their specific abilities and national sovereignties. In a co-operative manner - unparalleled to any international organisation – they overcome differences and manage diversity. They share the conviction that they should find European solutions to European problems. The Eurosystem is a perfect example for the co-operative approach that characterises the Union.
- Europe has always been open for new Member States. Membership is neither limited nor exclusive. Clear rules and procedures pave the way for newcomers to join the Union. Overtime, the ship has grown in size and quality. New members joined and new

competencies were acquired. In the nineties, the ship was given an important additional mast. This new mast is Monetary Union. Its strong sails push the ship further. They reinforce the strength of the EU and generate stability. In the coming months, this ship will be restructured considerably and will expand its crew significantly. It is doing this at sea. The day-to-day work of the EU continues; there is no break or pause that allows for practices or trial runs. The key challenge is to accomplish these tasks while keeping the three qualities. These qualities are worth maintaining. They have made the EU to what it is today. Let me now concentrate on the first task, the Constitution.

The Constitution

The EU has diverted from its traditional path of recurring Treaty reforms. It has decided to give itself a Constitution. Those of you who come from Central and Eastern European countries will be familiar with a process of adopting a constitution. In your countries the new constitutions have laid the foundation for an open society and democratic institutions. In the case of the EU, the new Constitution does not signify the start of a new political era. Why then has the EU embarked on a constitutional process?

Speaking as an outside observer to the process, it seems to me that the Constitution is to serve two purposes. The first purpose is renovation. The EU has to be made fit for the future. It needs well-functioning decision-making procedures and effective institutions. This is not only in view of enlargement but also in order to adapt to new international demands and changing economic circumstances. The second purpose is clarification. While concentrating on improving the strength and the size of the EU, accessibility and clarity might have been neglected over the years. The Constitution shall put this back in order. It seeks to make the EU and its decision-making process more transparent and comprehensible for the citizens. So, Europe is given itself a new Constitution to consolidate existing achievements; to codify key objectives and common values; and to provide a stable and effective foundation for the future.

The EU has embarked on a special method for drafting the new Constitution. As you know, over the last one and a half years representatives from national and European institutions discussed in the Convention what Europe's new Constitution should look like. The ECB has followed these debates with great interest. It welcomes the draft Constitution as presented by the Convention in June.

However, as central bankers, we had to learn a new lesson. For the first time since the setting up of the ERM in 1979, a major reform of the EU takes place without monetary integration being in the limelight. The reason is simple: as far as monetary integration is concerned the EU has reached a „sustainable endpoint“. The Maastricht Treaty gave the EU a modern „monetary constitution“ which does not need be changed. It is sound both in terms of the objectives set and the allocation of responsibilities between different actors and levels of government. The Convention rightly recognised this. Its draft Constitution takes over the provisions relating to EMU without changes in substance. The single monetary policy is, by its very nature, indivisible. Thus, it is an exclusive competence of the Union. The task of conducting monetary policy, as well as all

other central banking tasks, has been assigned to an independent European Central Bank, which fulfils the task together with the National Central Banks of the euro area and with the clear primary objective of maintaining price stability. The draft Constitution explicitly mentions the European System of Central Banks, the ESCB, in the first part of the Constitution. Thus, it acknowledges the federal nature of the monetary authority of the European Union and its sui generis character. Finally, the more specific provisions concerning monetary policy in the current Treaty as well as the Statute of the ECB and the ESCB will in their substance remain unchanged and form part of the constitutional texts of the Union.

I very much welcome that the fundamental features of the current set-up of EMU have been preserved. After all, the stability of the institutional architecture is a crucial element of the credibility of the single monetary policy and the public's confidence in our currency.

Of course, further refinements to the draft Constitution are possible, and the ECB has made several suggestions. For example, we strongly believe that price stability should be added to the list of the Union's objectives set out in the first part of the Constitution. Because Price stability is of great importance not only for the ECB but for the Union as a whole. It ensures confidence in the long-term value of the euro and translates into low and stable medium and long-term market interest rates. It also avoids an abitrary redistribution of wealth, thus it helps to protect the weakest members of society. Price stability certainly deserves to be an objective of the European Union. Furthermore, we would like to see a clarification of the allocation of responsibilities concerning the international representation of the euro. It would also be useful to recognise the widely used term „Eurosystem“.

Naturally, in all our comments the ECB does respect the prerogative of national governments and ultimately the citizens to adopt the institutional framework of the EU. At the same time, the ECB has a clear interest for the constitutional process to be a success. In this, I completely concur with what my predecessor, Wim Duisenberg, repeatedly stressed: for a well-functioning monetary union a strong and effective EU is necessary. EMU contributes significantly to the strength of the EU but without a political Union and effective institutions the ship will lose balance.

Therefore, I would like to comment briefly on provisions in the draft Constitution that concern the overall political institutions and procedures of the EU. I think, it is to be welcomed that the draft Constitution increases the visibility and continuity of the key representatives of the EU. A new elected President of the European Council and a strong EU Foreign Minister will help to put faces to decisions. I also support the extension of qualified majority voting. The EU may not necessarily acquire new competencies. However, the EU should have the means to implement effectively those competencies that have been given to it. Qualified majority voting ensures that decisions are actually taken.

It is now for the Intergovernmental Conference to use the Convention's draft for finalizing the Constitution. In this regard, I look forward to listen to the discussions at the first panel of tomorrow's congress.

Enlargement

The upcoming enlargement of the European Union is without any doubt a major achievement and a challenge. The ten new members will almost double the number of current Member States and the EU population will increase to more than 450 million people. Looking beyond these numbers, the largest ever expansion of the Union will be a historic landmark. It will underline the end of decades of division and reunite the European continent. Enlargement will also bring benefits in a more narrow economic sense. Both new and current Member States alike will be able to enjoy the benefits deriving from the expanded internal market.

Both the current and new Member States have been preparing intensively for enlargement. Let me first focus on the situation in the acceding countries and then on the European Union. I will finally concentrate on a specific aspect of enlargement, which is of particular relevance for central bankers – namely the extension of the euro area.

Acceding countries have made remarkable progress in recent years. They significantly furthered macroeconomic stabilisation and structural reforms. Moreover, those acceding countries that were formerly centrally planned economies have been able to establish functioning market economies, thus pursuing the process of transition.

There remain, however, formidable challenges. The task at hand is to advance real convergence while safeguarding and, where necessary, enhancing macroeconomic and financial stability. In particular, locking in inflation at low levels, preserving the soundness of the financial sector and renewing efforts towards fiscal consolidation are all of the utmost importance.

The gap in per capita income between the current and the new Member States remains large. The process of catching-up in real incomes has been slower than many expected at the start of transition, although the progress achieved differs somewhat across countries. For acceding countries as a whole, per capita income today is less than half of the average of the euro area. Given the very low starting point for most countries, increasing prosperity and living standards will remain their main policy objective for quite some time.

Of course, accession to the EU is expected to have a positive effect on the countries' prospects of convergence. The full integration into the internal market will increase growth prospects and thus foster the catching-up process. New Member States will have to complete the adoption and, even more importantly, implement the acquis communautaire (excluding, for the time being, those areas where transition arrangements apply).

Turning now to the current Member States. The EU has also been preparing intensively to make enlargement work. Member States took steps in the Treaty of Nice to streamline their decision-making. As I already mentioned, the ongoing process of giving the EU a constitution is also linked, at least in part, to enlargement. Within the realm of central banking, the Eurosystem has been engaged since 1999 in a constructive dialogue with the central banks of accession countries. The institutional structures of the ESCB are also being adapted and Governors of the central banks of acceding countries already take part as observers in the General Council. Finally, and most visibly perhaps,

the ECB has submitted a recommendation on the voting modalities of its Governing Council, which has been accepted by the EU Council and is now under ratification. This will allow the ECB to maintain the efficiency and timeliness of decision-making in an enlarged euro area.

In fact, enlargement of the EU will lead to the extension of the euro area some time in the future. New Member States enter with a commitment to strive towards the adoption of the euro. Let me stress that the basic interest of the euro area in this process is to ensure that the monetary integration of the new Member States proceeds in a smooth manner and in line with Treaty provisions. This has two important implications.

First, given the heterogeneity among acceding countries in their economic structure and their exchange rate regimes, no single path towards the euro can be recommended to all acceding countries. At the current juncture, the ECB does not discourage any particular strategy, provided it is based on sound economic reasoning, conforms to the existing institutional framework and contributes to the high level of nominal and real - namely sustainable – convergence, which is of the essence when joining the euro.

Secondly, the principle of equal treatment will continue to apply throughout the entire process of monetary integration. Adopting the euro is an extremely serious affair and it is of the utmost importance that countries fulfil the convergence criteria in a sustainable manner before adoption of the euro, as stated by the Maastricht Treaty. There will be no additional criteria but there will be no relaxation of the criteria, either. No more, no less.

Returning to the theme of identifying Europe, enlargement exemplifies the inclusive nature of the EU. The newcomers join the Union on the basis of a rules-based process and as equal members of the team. Moreover, enlargement will advance the EU's objectives. It contributes to prosperity, stability and peace. Finally, the many preparations for enlargement, both by the EU and by the acceding countries, provide a vivid illustration of the willingness among Member States to implement European solutions to European issues.

Conclusion

Ladies and Gentlemen,

The European Union can be proud of its qualities, its clear objectives, its willingness to co-operate and its openness to „newcomers“. I am optimistic that despite the profound tasks that lay ahead the EU will maintain these qualities. Europe will sail on with a strengthened crew and a modernised ship.

Yet, we all have to play a constructive role in this. There are investments to be made for rebuilding the new Member States and there are financial services to be integrated into one European market. I sincerely believe that Monetary Union contributes to accomplishing these tasks. The euro has become a strong symbol of Europe. It makes the world „identify Europe“ and helps Europeans to identify with Europe. I am grateful that as new President of the European Central Bank I have the opportunity to ensure that the euro will continue to stand for a successful Europe.

Thank you for your attention.

Identify Europe

Petra Roth

Ladies and Gentlemen,

It's a great honour for me to welcome you at the Frankfurt European Banking Congress 2003 - the thirteenth - here in the Alte Oper. This congress is a joint venture of Dresdner Bank, Commerzbank, Deutsche Bank, the City of Frankfurt and it's Economic Development Corporation, supported by Deutsche Bundesbank and organized by the Maleki Group.

It was established in 1991 to underline the importance of Frankfurt as a financial center in European monetary policy as well as in banking and international financial markets. I think this year's motto for the European Banking Congress is very fitting. The European Union has reached a very important stage in it's development. On the one hand, the European Monetary Union has all in all proven to be a good instrument of integration and has really helped Europe on its way.

On the other hand the past years' experience has also shown clearly that Europe's worldwide political weight is still not what it should be. Because of its apparent economic advantages, the European Monetary Union was easier to promote than the European political union. Accordingly, the results of the EPU Inter-Governmental Conference were somewhat vague.

However, after that and especially with the Summits of Amsterdam and Nice we could see some progress as to the question of the political union. And currently the draft Constitutional Treaty prepared by a Convention, which is to give Europe a clear direction is of utmost importance. It is quite obvious that the relations between the European Parliament, the European Council and the Commission is a highly sensitive matter. Up to now the dominating concept was that of the Intergovernmental Conferences, following the spirit of a Europe of distinct nation states. We know that this approach is not sufficient. European integration must be democratized.

Decision making procedures need to be transparent. There is the concept of the Federalists, which aims at the European Parliament as a strong legislative power and the Commission as a strong executive body. This is an efficient approach, but it neglects the important question of how in a federal Europe undesired centralizing tendencies - direct and indirect - can be avoided. That's the job to be done by European governments. This is not an easy task, especially when you think of the time schedule, accord-

ing to which this work should be completed and agreed before the next European Parliament elections in June 2004.

The European constitution will be far from perfect but without alternative, I am convinced. „Enlargement and the Constitution are two sides of the same coin," so Chancellor Schröder said. This view is shared by Great Britain's Foreign Secretary Jack Straw, who claimed:

„A Constitution was needed in order to make enlargement work better." It is easy to see that with this background of European integration there are many new chances and risks for banking in Europe. And of course the continuous process of integration will lead to an extension of the Euro-zone. Today's three panels, Constitue Europe, Strategic Options in Banking and Euro Extension will deal in greater detail with these questions of the future development of the European Unity. The organizers of the Frankfurt European Banking Congress have once again succeeded in gaining eminent personalities for the different panels. Therefore I would also like to thank you, the panelists, for the City of Frankfurt am Main for contributing to the success of this conference. We are proud to host the European Banking Congress in our city. Frankfurt is a good choice. It is not only an important financial center with the European Central Bank, Deutsche Börse AG and more than 2.200 financial service businesses.

And with a GDP of 151 billion Euro you can say that the Frankfurt Metropolitan Area contributes quite substantially to the economic development in Germany and Europe. Of course I also hope that you will have some time to find out for yourself that Frankfurt is also a worth visiting.

Ladies and Gentlemen,

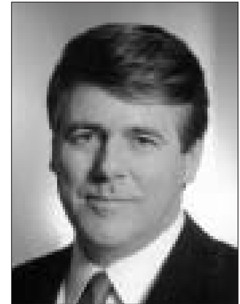
Finally I would like to express my gratitude to those who have made this congress possible, especially to you, dear Dr. Ackermann, Chairman of this year's Frankfurt European Banking Congress.

Last but not least I want to thank you, the participants, for attending the conference.

I wish you a successful congress and interesting talks on interesting issues.

Thank you.

Identify Europe



Josef Ackermann

Lord Mayor, thank you for your kind opening words.
Excellencies, Ladies and Gentlemen,

Let me welcome you, also on behalf of my two colleagues, Klaus-Peter Müller and Herbert Walter, who due to illness regrettably can't be with us today. Thank you all for coming. I am convinced we can look forward to open-minded and thought-provoking debates at this year's European Banking Congress, the 13th, in Frankfurt's Alte Oper.

We are meeting today at an important point in time for European integration:

- In less than six months, the EU will see its largest-ever expansion – from 15 to 25 members, from 380 million to 455 million citizens.
- The Intergovernmental Conference, which has the task of negotiating a European constitution, is in the midst of its work.
- In the economic area, Europe has suffered from three years of very weak growth, but now we are in recovery mode. The forecasts are cautiously optimistic, with an upswing anything but guaranteed.

Our conference motto, „Identify Europe", is undoubtedly a rather ambitious one. It requires a vision. The discussions may leave us with more questions than we can answer in the course of this one day. What is the specific European identity? What is it that keeps „us Europeans" together? Is it an idealistic vision based on common values? Is it our cultural heritage? Is it the economic Europe, the common currency and the shared European social model? Where are the European borders? And what about the institutions that represent this Europe?

The debate on all these issues, on the economic and political future of Europe, is in full swing. By way of introduction let me make three observations, regarding three different dimensions of our conference topic.

„Identify Europe” – this reflects, first, the geographical dimension, which forces us to think about the borders of Europe, or rather of the EU. Obviously, Europe and the EU are not synonymous. Europe has many contours and many faces, far more than the Union. But the European Union has decisively shaped the destiny of Europe.

The EU has proved to be attractive. A large number of countries regard the EU as a sort of „promised land“ and thus want to join the club as soon as possible. This is truly something to write home about. The European project of unification is indeed unparalleled in the world. The EU offers a framework for states to cooperate in promoting democracy, preserving peace and political stability, besides providing a solid basis for enhancing economic prosperity. It thus represents a remarkable reversal of previous centuries of division and conflict in Europe. The European model of voluntary cooperation for political governance may even serve as an example for other parts of the world for solving their quarrels. Ironically enough, these achievements are often recognised more clearly from the outside than from the inside. Within the EU, acceptance and satisfaction among EU citizens regarding European integration have been diminishing for some time. This should be thought-provoking for all of us.

Today, the EU is on the eve of shifting its borders to the east. By May next year, more countries deeply rooted in European history and European culture will become members of the Union. These countries have covered quite a distance in political and economic terms. Most of them have emerged as dynamic economies out of the long-term stagnation before 1990 and the sometimes painful reform process afterwards. They will have to cope with the increasing competition in the Single European Market. The catch-up process is still under way and will take its time. This has implications for the participation of the newcomers in monetary union. I expect this to be a point of discussion in our third panel, „Euro extension“, this afternoon – which, as I am happy to say, will be with the participation of the new president of the ECB, Mr. Trichet.

Next year's wave of EU accessions will certainly not mark the end of enlargement. The Union's borders are in flux and will continue to change in the foreseeable future. While this is to be welcomed we should not underestimate the time the EU will need to digest the current enlargement.

Beyond the narrow focus of membership the EU should work on concepts for exporting political stability and economic prosperity to adjacent regions. The former „Iron Curtain” must not be replaced by a „Brussels Lace Curtain”.

„Identify Europe” – has, secondly, an economic dimension. The economic dimension relates to the successful, far-reaching economic integration through the single market and the common currency. The euro, in particular, has reinforced the process of identifying Europe – maybe even more in psychological than in economic terms. We can only encourage those countries still agonising over the decision on EMU participation to cross the Rubicon.

That is the positive side. There are other voices, however, that tend to identify Europe as a stagnating, sclerotic economy shackled by an outdated model of a social welfare system. Indeed, economic performance recently showed a huge gap between

the US, with an annualised growth rate of some 7% in the third quarter, and the euro area, which did barely better than stagnation.

It cannot be denied: Europe has a growth problem, and the generous welfare system is to some extent part of this problem. Probably most of us agree that the European social model should not be fully congruent with the Anglo-American model. Social aspects and sustainability will continue to play a much more pronounced role than they do in the US. But the post-war European welfare state needs to be subjected to a thorough clean-up. This is necessary because of, among other reasons, the coming demographic problem. We have to find a new balance between what is economically bearable and what is socially desirable. Increasing the level of employment, for example, is not only the best social protection but also the key to higher growth rates in Europe. We have to act quickly, because the world around us is moving ahead at its own speed. There are bold and powerful competitors who were not even on the map a few years ago, such as China.

The Lisbon agenda of March 2000 provides the road map for reforms. Priorities, as set in Lisbon, have not changed since then. Nor have the means of achieving the goal. But can any of us really be satisfied with the progress being made? I don't think so. We will not get away with muddling through anymore. Our economies need to be more flexible and dynamic in responding to the inevitable changes in the global setting. We have to do away with the highly regulated markets, the red tape, and reduce the fiscal burden on companies and individuals.

However, there is also some good news. Policymakers seem to be starting to act, with taxes being cut and pension systems being slimmed. These reforms, if made more comprehensive, might see a tangible payoff in greater economic dynamism. Only if we learn to embrace economic change in a spirit of renewal will growth return to Europe. Europe needs to be an economic powerhouse in order to be able to compete with the US in the world markets, but even more so to cooperate with the US in global policies on an equal footing.

Economic integration needs a boost. There are still too many barriers constraining cross-border integration in Europe. In financial services, for example, we are far from a single market deserving this name. Progress has certainly been made in some areas. But still too often, a national view of financial markets predominates. So the fragmentation of the capital markets persists. Germany's private banks are only too aware that a strong homebase is essential for international success – and the same logic applies to other European global players. After all they have to compete with US financial institutions which enjoy the benefits of a large, well-developed home market. Discussion on „Strategic Options in Banking“, the topic of our second panel this morning, will have to take this different point of departure in the competitive situation into consideration.

„Identify Europe” – has, thirdly, an institutional dimension. The European institutions were designed fifty years ago for a small club. And they have continued to serve quite well for decades. However, they do not fit for an enlarged and less homogeneous Union of 25 member states. Unwillingness to adjust our structures and decision pro-

cedures could endanger the entire European project. We must not allow the enlarged Union to degenerate to a free-trade area de luxe.

An essential guideline for the new treaty is that the enlarged Union must be able to take necessary decisions without undue delay. To achieve that, the European institutions (e.g. the European Commission) should become leaner, and they (e.g. the Council) should become more result-driven. In addition, decision-making procedures need to be more democratic and efficient. Here, unanimity often simply means inability to act, even when the vast majority of member states are in agreement. The Convention's constitutional blueprint offers improvements in all these areas. While far from perfect, it obviously is the best achievable compromise at the present stage of European integration.

The Union's envisaged constitution is an important treaty. It will govern the way the Union functions for years to come. Therefore, it is only logical that the Convention's draft treaty is discussed intensively. However, it should always be remembered that the impressive achievements in integration so far cannot be taken for granted. We have to handle the assets of European integration carefully and ensure their future development. The Intergovernmental Conference thus has to take up the political momentum created by the Convention. It has to make the constitutional treaty a forward-moving project.

Ladies and Gentlemen,
It is the task of our first panel to discuss these issues under the heading „Constitute Europe". May I now invite the panelists to come up to the stage and take their seats.

Constitute Europe

Gianfranco Fini

I think it is first of all opportune to give some information on the progress of work of the process of constitutional reform of the European Union subsequent to the opening of the Intergovernmental Conference and the meetings of the European Council and of the Ministers of Foreign Affairs of the Union.

The Italian Presidency is leading the IGC on the basis of precise methodological indications given by the Heads of States and Governments in Salonika and in Brussels.

The path of the Intergovernmental Conference is not without difficulties but it is certainly facilitated by the fact that we are working with a single text that is widely shared by the members of the Convention and has been approved by the European Council.

The different positions of some Member States on some issues confirm that the draft Treaty, as it was approved by the Convention, thanks to its fundamentally well-balanced nature, is still a basis from which we should diverge to the least possible extent. This is true both for the composition and the running of the European Parliament, Council and Commission and for the significant innovations we aim at introducing in the future Constitution (President of the European Council, Minister of Foreign Affairs of the Union).

It seems clear that the problems that have been brought up can neither be solved by „stepping back" to the positions in Nice, nor through an unrealistic „flight forward".

Stepping back to the positions in Nice would thwart the Conventions sixteen months of work; „flights forward" would risk leading to the failure of the negotiations. We must therefore find a realistic compromise as „ambitious and noble" as the one reached by the Convention, as I said in Brussels on October 15 last.

The most remarkable issues concern, as you know, the composition of the Commission; the calculation of the qualified majority; the status of the Minister of Foreign Affairs and, more in general, the Union's Foreign and Defence Policy.

With regard to the composition of the Commission, the front of those supporting the formula of „one Commissioner with right of vote per Member State", as it clearly emerged in the opening session of the IGC, is gaining new momentum.

The aspiration of minor countries must be considered in a positive way as a need to actively take part also in the running of essentially „European" institutions such as the Commission and not only in institutions representing the States such as the Council.

A path to follow should guarantee effectiveness, impartiality and legitimacy for the Union's executive through measures of organizational rationalization but without traumatically formalizing a division of two categories of commissaries with different rights.

With regard to the issue of the calculation of qualified majority in the Council, with the exception of Spain and Poland, there is a broad convergence on the principle of double majority, a principle that can hardly be abandoned.

This position, which had always been shared by Italy during the Convention, in addition to being more transparent and comprehensible, has following advantages:

- It facilitates the decision-making process;
- It highlights the double legitimacy on which the Union is based, i.e. the states and the peoples: as a matter of fact beside the majority made up by the number of states, whatever their size, the second criterion granting a different weight to the vote of each of them may not originate from an artificial deliberation as set out during negotiation rounds, but it should rather issue from the number of citizens representing them and who democratically legitimate them.

The issue of the Foreign and Security Policy raises two different sorts of problems: the first concerns the position of the Minister of Foreign Affairs, the second deals with cooperation in the field of Defence.

The creation of the new position of the Minister of Foreign Affairs of the Union – one of the most significant innovations introduced by the draft Constitution – defines a necessity all Member States share in the meanwhile.

As far as the Defence policy is concerned, there is a fundamental unanimity with regard to the updating of the „Petersberg tasks", the creation of a European Agency for the Defence Industry, the solidarity clause against terrorism and big catastrophies provisions on structured cooperation, whereas those on the clause of mutual assistance and more in general on the relationship between the European Union and NATO are more controversial. With regard to this latter delicate issue, the Italian Government deems it necessary to find formulas that, although providing for an autonomous European capability, are neither politically nor operationally detrimental to the fundamental transatlantic bond.

Basing itself on the draft of the Convention and on the work done by the Ministers of Foreign Affairs, the Presidency shall submit an overall proposal focussing on institutions and on defence that shall try and consider the needs of Member States, of accession and of candidate Countries.

This proposal should enable the „conclave" of the Ministers of Foreign Affairs of November 28-29 to define the limited agenda of the mid-December's session of the IGC from which we hope the final political agreement can issue on the Constitutional Treaty for the Union of the 21st century. It shall thus be possible to sign the future Con-

stitutional Treaty between May 1, 2004 when the ten new states are going to become members of the Union and the elections of the European Parliament.

With its new Constitutional Charter, Europe is moving from a purely economic dimension of a common market a single currency to a new political dimension, thus starting to become a community of values and rights that may play a more effective protagonist role on the world's stage.

Economic problems must however remain central. A larger political cohesion must enhance a larger economic cohesion, helping Europe to tackle a crisis that is not cyclical but structural and originates from a gradual loss of competitiveness and from a slowdown of economic development. Furthermore, as of May 1, 2004 when the ten new countries shall formally become members of the Union, the scenario of the European Union shall remarkably change. The European reunification is a huge opportunity but it is not lacking problems wich it is worth while mentioning.

The Commission presented a Monitoring Report on the state of preparedness of the new EU member states for EU accession on November 5. Such a report evaluates as the general level of preparedness of the accession countries satisfactory with regard to their degree of implementation of the acquis communautaire; however, some gaps have been identified and some of them raise serious concerns.

Should these gaps not be filled by the end of May, the Commission shall not hesitate to activate the „safeguard measures" as provided for in the accession act. These provisions enable the Community executive to temporarily exclude the new member countries from some benefits, should the provisions not be observed.

More in detail, among the gaps raising concerns a first group of greater economic importance must be identified concerning the internal market and mainly the acquis to protect (a) the safety of foodstuffs and (b) the competitiveness among companies. As long as these gaps are present, „unsafe" products and the companies breaking competitiveness rules could be excluded from the internal market as a consequence of above mentioned safeguard measures. A second group of deficiencies concerns on the contrary the acquis on the management of aid to agriculture and in this case the safeguard measures would block the refund to the governments of the new member states of the aid they granted to their farmers.

It is furthermore necessary to bear in mind that the Euro-group countries shall be fewer than those keeping their local currency. In the Ecofin Council, therefore, the Ministers of the Euro-group shall be in a minority and the Council itself, while implementing the requirements of the majority, could potentially deliberate to the detriment of the Euro-group countries.

In addition to intentionally mentioning the „Euro-group", still remaining an informal body where only the Ministers of Finance of the Euro-zone take part, the draft Constitutional Treaty provides for a sort of „safeguard system". In particular it provides that the adoption of some measures that are specifically related to directions of economic policy is reserved to the Ecofin Ministers of the Euro-zone countries. Furthermore, the Treaty provides that some provisions concerning the economic policy of the Union are not applied to member states that are not part of the single currency group.

The Ecofin Ministers of the Euro-zone hope that the IGC represents the occasion to further enlarge the range of autonomy acknowledged by the draft Treaty. They ask on the one side to enlarge the scope of the measures adopted by the representatives of the member countries using the single currency; on the other side they hope to broaden the range of provisions that are not applied to member countries outside the Euro-zone.

The difficult international economic situation and the difficulties in reviving the national economies of many member countries of the European Union have stimulated reflections on the adequacy of the present management system of the European monetary policy and of the rules fixed by the Stability Pact with regard to the need to revive economic growth.

The relevance of these reflections has been highlighted above all when considering the difficult situation of some of the most important European economies, where deficits have long exceeded the threshold of 3% in the deficit/GDP ratio as it was set out by the Stability Pact tiggered again the discussion on the opportunity to further soften the obligations of the Pact through flexible solutions capable of preserving its core and credibility.

In this sense the most sensible issue is no doubt the one regarding the possibility and opportunity of a real application of procedures in case of an excessive deficit (art. 104 of the Treaty).

The discussions of our Ministers of the Economy presently focus above all on interpretation assumptions with regard to the provisions of the Treaty providing for the start of procedures for excessive deficit against member States, in order to find a scope of flexibility also in this case and thus enabling to both preserve the formal respect of the rules set out in Maastricht and the needs originating from situations related to the economic situation showing a slackened economic growth.

In particular, the Ecofin Council of November 4, following a proposal submitted by the Italian Presidency, decided to adjourn the discussion on the French public deficit to the next session on November 24 and 25 in the light of the commitment of the French Economics Minister to find new budget measures for 2004 permitting to meet better the requests of correction made by the Commission.

It is necessary to use the same momentum for new objectives and the same mechanisms used to give birth to the euro. When faced with the challenge of the emerging countries, it is not a matter of raising customs barriers but rather to follow the path of innovation and research, implementing „big material and immaterial projects" following the wording used by President Ciampi in his meeting with the Commission in Brussels (October 2, 2003).

Building infrastructures, investing on big works in order to implement an effective transport and communication network is necessary but it is not sufficient because our bet on the future is at stake also on European competitiveness, which can be tackled by investing in research and innovation. If the European economy has long not been able to compete with the American one, there is an underlying reason: Europe invests too little on research.

The economic and social future of Europe is linked with the progress of knowledge. This deficiency is particularly serious at a time when more and more the creation of a European space of research and innovation is requested going alongside with the domain of the currency, while overcoming present national imbalance and promoting the sharing of different knowledge and resources.

Research is underway but it must become more and more a priority for Europe. Already in March 2002 the European Council of Barcelona had set out the ambitious objective to bring investments in this field up to 3% of the GDP. With investments reaching 3% of GDP by 2010, a surplus of economic growth amounting to 0.5 of the yearly GDP should be achieved.

The creation of the „networks of Knowledge" that the European Council of Salonika of last June, as well as the Brussels summit of October 16-17 have pointed out to be one of the key elements for the economic growth, is in line with these considerations.

The Italian Government is determined to make these issues the axis of their European policy. We are facing a challenge of historical importance that must be tackled with a great sense of responsibility and the awareness that we are working at the construction of the Europe of the future. A Union with a strong economic, political and cultural identity that may at last speak with one voice on the world's stage.

Constitute Europe

Csaba László

Thank you Mr. Chairman, Mr. Minister, Ladies and Gentlemen.

As a financial expert and former banker I think this is a great opportunity for me to talk here about the "new" Europe, about enlargement. In my view this is a good occasion to talk about business and politics in the financial centre of Germany, because I think business and politics should go hand in hand. There is no good policy, no successful politician in a country where business does not flourish and vice versa.

First of all let me talk about enlargement from my point of view and about some specific features of Eastern Europe. The fifth enlargement of the EU can be considered the largest one in the last twenty, thirty, fifty years by far, not because of geography, from Malta to the Baltics, from Poland to Cyprus, but because there are so many differences between the current member states and the newcomers.

There are large differences concerning history, tradition, geography, and economic circumstances. The enlargement means both challenge and opportunity for the "new" and "old" member states. Although one thing is for sure, that all the newcomers are really working on the final stage of preparation for the EU accession. Sometimes we are acquainted by experts in Brussels that we are more prepared in many aspects of our duties than some of the "old" member states. I don't think we have the right to be complacent but we still have more than five months to start with the European accession.

Concerning economics, this enlargement will be very much different from previous ones. Fifteen, twenty years ago, joining the European Union meant a kind of shock to the economy because of elimination of customs duties and harmonization of many other regulations. Currently the accession countries are already very much integrated into the European economy. Let me take our country as an example. In Hungary we have a small and open economy. Hungary has already integrated into the EU economy in such a high extend which exceeds the integrity of other EU states. About 70/80 per cent of GDP results from foreign trade and about 80 per cent of our foreign trade is with the European economies. So I do not believe that the same kind of shock can be experienced as fifteen, twenty years ago in the steel industry, in the mining industry or in any other sectors of the economy. Customs and duties are already very low, besides regulations and legislative frameworks have been adjusting more and more to the European ones in the last ten years. On the other hand there could be only one big

exception: agriculture, where we have to apply the Common Agricultural Policy, which will be a serious challenge for that sector. Agricultural circumstances show similarity with most of the other member states.

Although geographically Hungary has convenient agricultural circumstances the importance of agriculture in the whole economy is getting smaller and smaller in the last ten/twenty years. Of course we have to apply most of the regulations and requirements from next year and we are more or less prepared for them, on the other hand we have to face one of the main difficulties, which is the preparation for EU funds effectively.

In my view reducing red tape, bureaucracy and administration in the coming years is quite a significant challenge to the newcomers as well as the "old" member states. So this is where business and politics should work together in the future.

In the last ten months after the Athens Summit we have had the chance to integrate into the decision-making process. Although we are not yet voting in the Ecofin Council or in the European Council, we are already part of the whole procedure, which means that we will be able to start work without any hardship next May. We are participating in all official and informal meetings, we are taking part in private talks and in behind the scene discussions. I am convinced that this is a very important training period for us. On one hand we are getting more and more involved into the decision-making processes, on the other hand we can create even more personal relationships. During the Greek and Italian presidency we have had great opportunity to prepare properly for the real work from 1st of May 2004.

Of course as the finance ministers we are working on the Stability and Growth Pact.

I share the views of Minister Fischer that next Tuesday, for example, during the Ecofin meeting we have to find a compromise on the most of the current issues. The newcomers are bringing many things to Europe but one of the most important is growth potential, I am sure. That is the topic which could be the point of further discussions.

In the last ten to fifteen years, I am sure that we have initiated and implemented sometimes more serious reforms than the EU member states. There is no Ecofin meeting currently, when pension reforms are not in the agenda as it is an important topic to be discussed for the accession countries and the "old" member states as well. For example Poland, Hungary and Slovakia have initiated quite comprehensive reforms in the past. The other significant field is taxation and tax reforms related to which we can share our experience.

When we were evolving our own economic policy last year, we decided to put our focus on the word 'competitiveness'. It is the other current issue related to the whole Europe and it just confirms the principles of the Lisbon strategy. In the case of a company or a bank competitiveness means improving efficiency, having better PR, etc. We have to focus on similar aims to support competitiveness on the state level.

After the accession we wish to pursue an economic policy, which ensure the further continuous decrease of the government deficit and the inflation. Last year we had more than 9 per cent of GDP in deficit in Hungary, this year it will be below 5 per cent, next year it will be reduced to 3.5 per cent and by 2006 we have to achieve 2.5 per cent.

Besides concerning wage policy as well as monetary policy we have to continue reforms as well.

I have already mentioned efficient use of EU resources. These can really help infrastructure, environmental policy, regional developments and of course the competitiveness of the whole economy. At this point I would like to emphasise the Italian initiatives, the growth initiatives, which confirm that we have to focus much more on investment in the budget, not only at the European level but at the national level as well. This is one of the reasons why we are increasing our investment expenditures in the budget by more than one per cent just from one year to another. Our aim is to support foreign direct investment. Some surveys show that FDI in the region and FDI in Europe are slowing down but I believe that FDI will face a crucial growth in the future, thereby increasing competitiveness in Europe.

I am not talking about FDI in Hungary, but I am talking about Hungarian companies investing for example in Slovakia, in Romania or Bulgaria and vice versa.

And finally I would like to say some words about the euro. The common currency could be a main challenge for us. In the past we were called a planned economy but long-term planning was not just necessary and crucial in the past. Now we have to set up a clear programme for euro accession. The government's Pre-Accession Programme of 2003 reckoned with the introduction of euro in 2008 and in agreement with central bank we would like to join the ERM II system as soon as possible because it can stabilise financial systems and exchange rate mechanisms.

Yesterday I just had a chance to visit Mr Eichel in Berlin. I had the feeling that for example Germany supports us very much and favour a consistent strategy and implementation in this respect, which means that as soon as possible we would like to join ERM II after joining the European Union next year.

Of course this enlargement was a very brave step by the European Union and of course all brave steps mean high risk as well. Bankers are very much aware of risk. And of course we have all the risk management procedures and tools in our hands. At the country level it is somewhat different. But if we have a successful enlargement in the coming years, it could really set an example for the whole world and gain friends and supporters for the European model not only in the world economy but in the world politics as well. It could give a green light to the further enlargement and our Romanian and Bulgarian friends are already very keen on joining the European Union as soon as possible. If this enlargement could be successful we can really go further on this path. In my view this is a historical moment because with a successful enlargement, Europe with is own culture, tradition and history can have a more leading role in the world and could be more efficient and of course provide better life for all citizens. And that's our job in the future and this is why we are here and discussing today these issues. Thank you Mr. Chairman.

Strategic Options in Banking

Josef Ackermann

Ladies and Gentlemen,

Regrettably, the chairman designated for this panel, Herbert Walter, cannot assume his position here due to a sudden illness. His misfortune gives me the unexpected pleasure to chair this panel, too. „Strategic Options in Banking", the title may sound rather unambitious but the questions that lurk behind it are indeed the „big" questions of the banking industry. Which strategies promise success in the banking industry? Or, even more provocatively: Do banks as we know them today have a future at all? These questions, of course, do not command definite answers. However, discussing strategies as possible trajectories into the future remains as necessary as ever. In fact, it is very encouraging having just such a discussion here in Frankfurt. It is not that long ago that some German bankers were not in the position to take the necessary time to think strategically about the future, because day-to-day operations required their full attention.

Prior to any discussion about strategic options, the groundwork must be in place to ensure that theoretical possibilities can be turned into reality. If present operations are too demanding, the discussion about future strategies degenerates into day-dreaming: Strategies have to be founded on a profitable core business, and a profitable core business requires doing one's homework in terms of cost and efficiency improvements.

German banks – on average – still have some homework to do to catch up with the profitability of their competitors. We are not out of the woods, as the British say, but we can see daylight beyond the trees. The year-long weakness of the German economy is being overcome, and the enormous level of write-offs that hit German banks in 2001 and 2002 is set to decrease markedly in 2003. Furthermore, the excessive cost levels which to a large extent resulted from expensive investments in capital market and IT activities have been brought down to sustainable levels.

I am convinced that during the next hour and a half we will have a very active and animated discussion about what banks' strategic options look like going forward. We invited senior managers of leading banks and consulting firms who all have clear visions of the bank of the future (depending on who will finally be on the panel). Around a

single conference table we have gathered top managers whose business is strategy and top managers whose strategy is business. In alphabetical order:

- There is Hans-Paul Bürkner, who will become the new president and chief executive officer of The Boston Consulting Group. After joining BCG in 1981, Mr. Bürkner has founded the Frankfurt office in 1991 which he lead until 1997. Mr. Bürkner will not only be the first European to take on the top position at BCG, but he has also announced to keep his office in Frankfurt in addition to New York.
- Our second panelist is Karl-Heinz Flöther, the chief executive of Accenture's Financial Services operating group and a member of the company's Executive Committee. Mr. Flöther joined Accenture in 1979 and became a partner in 1990. Before assuming his current position, he was responsible for the Financial Services practice in Continental Europe and served as country head for Germany.
- Our third panelist Mr. Hans-Joerg Rudloff is the Chairman of the Executive Committee of Barclays Capital. Being born in Cologne in 1940, Mr. Rudloff joined Credit Suisse-First Boston in 1980. He has spent many years as a member of the Executive Board of the Credit Suisse-First Boston Group. In 1998 Mr. Rudloff joined Barclays Capital to assume his current position.
- Our fourth panelist is Martin Blessing, member of the Commerzbank Management Board. Mr. Blessing joined Commerzbank in 2001, responsible for retail banking. Prior to that he served as Chairman of the Board of the Advance Bank in Munich. Our thanks to Mr. Blessing for joining this panel at the last minute to replace others who couldn't be here today.
- Completing our panel is Dr. Horst Müller, member of the Management Board of Dresdner Bank and Allianz AG. Dr. Müller has worked for Dresdner Bank for 33 jears, joining the board in 1992, responsible as director for employee relations (Arbeitsdirektor). Following the integration of Dresdner Bank and Allianz in 2002, an important aspect of his work the concentration on the strategies of an integrated financial service provider.

Given the many aspects and related questions, discussing strategic options in banking in just one and a half hour seems a fairly tall order. However I am sure that our exceptional panel will nonetheless produce some very valuable insights.

Strategic Options in Banking

Hans-Paul Bürkner
Karl-Heinz Floether

Faced with difficult market conditions, executives in the financial services industry recognize that to bring their companies back to the path of value creation, they have to find new answers. The purpose of this analysis is to describe strategic options for the banking industry today. As we will illustrate, the winners will be those institutions that choose a differentiating strategy, align their business model and capabilities to it, and stringently manage for profitability and growth within this framework.

I Context: The Banking Industry in Crisis?

1. Growth, Hype, and Crash

The 1990s were a landmark decade for the banking industry. Driven by globalization, deregulation and fundamental technological changes, it saw real transformation. The Basel Accord of 1988, the fall of the Soviet Union and its satellites, the establishment of the European Single Market, and national deregulation, combined with global GDP growth and the rise of advanced communication technologies, created new options in banking. Despite the fact that the number of banks has declined by over 30 percent, banking has remained the largest global industry—throughout the 1990s, its surviving players thrived, growing earnings at an impressive 12 to 14 percent each year.

This buoyant economic period was interrupted by a crisis of confidence in emerging markets. The Asian and Russian economic and currency crises penalized the banks that had overreached in expanding abroad, especially those that took on significant risks in emerging markets to reap greater returns. Some banks failed, and others were taken over. The global financial system was shaken to its foundations.

Central banks reacted to this crisis with interest rate cuts: an effective strategy. Growth resumed?or perhaps more aptly, hype prevailed. Exploding demand for equities on the part of private and institutional investors, largely induced by unattractive interest rates for classic savings products, prompted heavy investment in new activities. The M&A game began. Players like Deutsche Bank and Citigroup entered the investment banking business, many spun off direct brokerage subsidiaries, and others entered new and often risky geographic and product markets by means of takeover or alliance. Still others created B2B platforms. The promise of ever higher revenues and

profits, combined with proclaimed leaps in efficiency enabled by technology, caused share prices to rise to unforeseen levels before crashing in 2000. In overall industry comparison, however, worldwide banking nevertheless has been a conservative bet: outperforming the overall market in downturns and underperforming in upswings.

Despite all forebodings, the stock market crash in 2000 surprised everyone. The price-to-earnings ratio had been reaching levels as high as three times the 130-year historical average. For banks it almost doubled between 1995 and 2001. Self-declared stock market gurus forecasted a Dow Jones average of 36,000, arguing that economic fundamentals no longer applied—new technologies were the source of a paradigmatic jump in productivity. Warnings by others that markets were overheating, some as early as 1996, were ignored. When the crash materialized in 2000, most banks were in fact unprepared.

Taking total shareholder return (TSR) as a measure of banking performance, it is striking to note how much better banks in the U.S. weathered the crash than all the rest, and going one step further, how poorly German banks performed in comparison with their peers in Europe and the rest of the world. For instance, an investment of 100 $ in U.S. banks at January 1, 2002 despite the crash yielded 107 $ at the end of 2002, while a corresponding one in German banks ended up with only 46 $. However, since the second quarter of this year, we have also been able to observe a clear move towards recovery. Let's first consider the reasons for the poor performance of European banks over the last three years, and German banks in particular.

Many European banks had driven up investment and capacity but failed to prepare for the downturn. Investments had to be written off, direct brokers were reintegrated, and costs and personnel were slashed. As demonstrated above, German stocks were strongly impacted by the overall stock market downturn. High proportions of fixed costs, especially among German banks, made for dwindling profit margins. Furthermore, unfavorable economic circumstances drove up insolvency rates, and, consequently, loan loss provisions. In fact, from 2001 to 2002 insolvencies in Europe, including private ones, rose by 22 percent to over 240,000, with obvious effects for loan loss provisions.

This development affected Germany particularly hard: Between 2001 and 2002, the number of insolvencies went up by over 65 percent. German firms led the list of Europe's biggest corporate insolvencies among them Philipp Holzmann, Babcock Borsig, KirchMedia, and Gontard & Metallbank. The net income of big German banks plummeted to zero or negative, and some were able to produce positive numbers only with the sale of industrial holdings or profitable subsidiaries. During the crash, it became very clear that profitability of German banks is not satisfactory. In fact, profitability of the underlying business has not been a new issue for German banks. They managed to survive the 1990s relatively unscathed only thanks to a series of extraordinary events: German unification prompted a construction boom and a corresponding upswing in home loan and building society business. When this boom came to an end in 1996, the equity hype began banks started to create direct brokers and offered real-time access to stock exchanges. Concerns about the viability of the state pension system and deliberations about future taxes on life insurance caused a run on life and pension products.

And the new tax breaks on the sale of industrial holdings provided another extraordinary source of income. The sum of these special effects reduced the pressure on German banks to fundamentally restructure their businesses. In turn, the crash mercilessly revealed the three fundamental structural problems of the banking sector in Germany: high fragmentation leading to unrealized cost savings potential; the strong influence of public sector banking on price margins, and the undue weight that participant market values have on the values of the banks themselves.

2. Performance and Value Creation

The ultimate performance measure should be the value created for a bank's share holders. There are two ways to measure value creation performance:

- Economic performance, i.e., the bank's "internal" value creation: the result of increasing business profitability and finding profitable growth opportunities. Technically, economic performance is measured by the increase in value added, meaning the increase of excess profit earned as compared to that of alternative investments of similar risk.
- Market performance, i.e., the bank's "external" value creation: the value created for the shareholders or total shareholder return (TSR). Technically, TSR is the difference in market value from the beginning of the shareholding period to the end, plus any dividends paid out during this period.

Internal and external value creation is usually in lockstep over longer periods such as five years. Between 1998 and 2002 (the period analyzed below), German banks in general not only turned in poor market performance but also had poor economic performance. In contrast, these years were moderately successful ones for many of the German banks' European peers.

Looking at strategic implications it is more instructive to compare (historic) economic performance with current stock market valuations (the market-to-book ratio). The market-to-book ratio reflects stock market expectations in regard to the ability to earn superior returns in the future. Combined in a matrix, four groups can be identified: All banks seek above-average returns sustainable into the future in combination with growth potential. The "value generators" are those that reach this target, and they are rewarded with above-average market valuation. Their challenge is to retain high valuation with ongoing and efficient growth.

VALUE MATRIX		Historic economic performance (increase in value added	
		Low	High
Market expectations (market to book as of today)	High	Value pretenders	Value generators
	Low	Value destroyers	Value victims

The "value pretenders" have high market capitalization but failed to increase their economic value by improving profitability or growing in profitable segments. They include also companies "buying" market share in growing markets, expecting to increase tomorrow's revenues and returns with high investments today. The basic task for banks in this group is to justify their high market valuation by improving their economic performance (with a clear focus on profitable growth), otherwise they run the risk of a considerable loss of market capitalization.

Companies not able to achieve above-average market valuation find themselves in the lower half of the matrix. Here, the group of "value destroyers" shows historically below-average economic performance and still struggles to convince the capital markets of their ability to earn returns above cost of equity. This, in particular, is a key challenge for German banks that could be found with almost no exception in the lower left corner of the value matrix; looking at the performance of German banks in 2003, initial promising steps towards improved profitability can already be observed. By continuing especially to increase profitability, value destroyers can turn into value generators in a short period of time.

Banks that have below-average market-to-book ratios and strong economic performance are "value victims." The market does not expect them to be able to sustain their high level of value creation (anticipating lower-than-average growth or declining profitability), and accordingly punishes them with low market-to-book ratios. Therefore, the companies in this quadrant must prove that they can both manage costs and drive growth over the long term, and improve investor relations by better communication.

The question now is, how can you improve both your economic performance and your market performance?

II. Positioning, Profitability, and Growth: The Three Steps to Value Creation

There are three steps to create value for shareholders as the ultimate goal of management:

1. Who do you want to be and how to position yourself—find the strategy most suitable for your company!
2. Do your "homework"—push profitability above the cost of equity!
3. Go forward—grow in profitable segments!

It is important to differentiate clearly between these steps. After defining your strategy to sharpen your positioning and aligning your organization accordingly, you need to identify the businesses in your organization that fail to earn their cost of equity—since growing in those businesses would destroy value. First, it is imperative, by increasing profitability and downsizing if necessary, to get these parts of your organization closer to profitability above the cost of equity. Then you can and should expand them without allowing profitability to fall below cost of equity again. We will describe the three-step program for value creation in more detail below.

Moreover, let us stress that in addition, in looking at capital markets, it is of course important to keep your investors updated with consistent targets—and to deliver on

them. But building and maintaining good investor relations is beyond the scope of the present discussion.

1. Who Do You Want to Be and How to Position Yourself?

Until recently, many banks pursued indistinguishable strategies with similar service offerings. Now the markets are rewarding those that set themselves apart. Banks must define their value-adding strategies according to what they do best. They must assess their key strengths and determine their target customers, product portfolio, geographic markets and, most importantly, unique value proposition. Strategy must focus on the products and activities that put the company in a competitive market position, hold above-average potential, and optimize the bank's value over the long term.

Banks that set themselves apart outperform those that do not in annual growth and return on equity. This trend will become even more pronounced as the decade unfolds, with most banks falling into one of three categories: diversified banks, monoliners (specialists), and hybrids. Let us point out that in the context of the Accenture value matrix, diversified banks are also known as gorillas, monoliners as category killers, and hybrids as middle market hybrids.

a) Diversified Banks

Banks that achieve size and scale within their markets may be able to thrive as full-service, universal banks. There are likely to be three to five diversified banks at the global level, and 20 to 30 operating over major regions. Citigroup and HSBC are the best examples of diversified banks—they operate around the globe and are increasingly leveraging their capabilities across markets. When an initiative or offering enjoys success in one market, they are able to replicate this quickly in another one; and where a capability needs to be developed for several markets, they are able to build it once and deploy it in multiple locations, thereby reducing the cost of doing business. Deutsche Bank aspires to be a global diversified bank in this sense.

Diversified banks with a regional focus, like their global counterparts, apply a similar strategy, but in fewer locations. Examples are Nordea, BBVA, ABN Amro, Standard Chartered Bank, and the Royal Bank of Scotland.

b) Monoliners

At the other end of the spectrum, we are seeing the emergence of niche specialists or "monoliners." They focus mainly on one business segment and use their respective special expertise to become the market leader in that segment. There are global and regional monoliners. Again, we expect three to five to succeed globally for each product or back-office process. However, taking regional specifics into account, many more regional monoliners could succeed in their respective segments. American Express, MBNA, and Capital One, for example, already fill this role today for credit cards. Eurohypo in Germany and Washington Mutual in the U.S. are examples of regional monoliners in mortgage financing.

c) Hybrids

The vast majority of banks are still indistinguishable competitors. For them, the challenge will be the move to fully diversified banking, offering the full range of services on

a global or regional basis. The alternative is to focus on one segment and to succeed in the corresponding niche. Getting stuck between diversified banks and monoliners is not a promising strategy, since superior economic returns are unlikely with a lack of focus.

2. Doing Your Homework

Doing your homework means, first and foremost, increasing profitability above cost of equity in the segments and regions in which you choose to compete. If you are not earning your cost of equity, you have to downsize until your profitability reaches the hurdle rate investors demand. Insufficient economic performance caused by underlying profitability problems is currently the biggest issue for German banks.

We will now focus on the German banking market and highlight three major areas where efficiency improvements are imminent, namely credit portfolio restructuring, industrialization, and the breakup of the value chain. But first we want to emphasize that the focus should not be on efficiency alone. This leads only to undifferentiated cost cutting, which potentially harms core capabilities and ignores the power of (risk-adjusted) pricing. The management of efficiency must take place within the framework of the firm's strategy and business model. Each bank, depending on its chosen differentiating strategy and subsequent business model, must manage efficiency within this structure.

a) *Credit Portfolio Restructuring*

To assess the connection between revenues, costs, loan loss provisions, and net income, we did a regression analysis of German banks and their high-performing peers. The peer group exhibits a positive correlation between revenues and cost to net income. Costs have risen, but revenues have risen even faster, thereby increasing the returns for these players. In contrast, the German banks showed no correlation between revenues and cost to net income. Rather, net income is largely explained by the level of loan loss provisions. Interestingly, looking at the broader German banking market, one finds that the level of loan loss provisions at 0.4 percent is comparable to the averages of other countries. U.S. commercial banks, for example, had loan loss provisions around 0.7 percent of total assets in 2002; countries such as Australia, UK, the Netherlands and France had levels between 0.1 and 0.3 percent.

All the big German banks are in fact struggling with the problem of dramatic increase of loan loss provisions between 2000 and 2002, with compound annual growth rates between 43 and 206 percent. These increases are a result of the particular strategy of big banks to focus their banking business on very large companies while neglecting loans to SMEs and retail loans. Some of these large companies have foundered (see above), each causing hundreds of millions of Euros in damage to the banks' profitability. Risk management is therefore the number one issue for German banks, especially the big ones with focused corporate banking strategies. The solution is the establishment of tools for measuring risk on a much more sophisticated level, the implementation of risk-adjusted pricing for each individual loan, and the development of an efficient portfolio management. The initiatives for countering the risks of inadequate risk management are on the way: German banks are already implementing processes and technologies to conform with Basle II, but a lot still needs to be done until full portfolio

transparency and adequate portfolio management are realized. The restructuring of non-performing credit portfolios is becoming more important; one way to handle the issue is to establish internal "bad banks" like the Dresdner Bank's internal restructuring unit.

b) Industrialization

1. Automation

Automation, a major component of industrialization, has considerable potential made possible by new technologies. For example, while 99 percent of domestic payments are handled by straight-through processing systems, this applies to only 33 percent of cross-border payments. Potential can be observed not only by the achievement of domestic processing rates, but also by the fact that in Germany, for example, less than 0.4 percent of transactions in 2001 were cross-border, their total number hampered by high prices and inadequate bank automation. Industry insiders in the U.S. argue that 25 percent of all cross-border trades fail or need serious intervention, and that over a third (37 percent) of these failures can be attributed to late, unspecific, or invalid trading instructions or stock/cash mismatches.

Credit scoring is another area where automation is relevant. The manual audit and assessment of credit inquiries is a complex topic that can be simplified with automated credit scoring processes. These allow early detection of credit risk but leave the decision of credit allocation with bank employees. Banking experts are demanding that banks stop trying to make their credit policies "works of art" and move to more standardized, automated processes with efficient sales and execution. The German Norisbank offers "easycredit," standardized consumer credit that is also marketed through partner banks and cited as a best-practice example in German banking.

2. Process Efficiency

Process efficiency is closely related to automation. But not all processes can be automated—which is why the interfaces between people and technology have to be considered. The aim must be to optimize processes to minimize manual input, and the ideal is "one and done." Process efficiency is nothing new for banks. In fact, it seems that streamlining processes in the same way it has been done in the past will not unleash further savings potential. The true quantum leaps in process efficiency can be achieved by reducing complexity.

3. Professional Sourcing

German banks' professional sourcing activities have traditionally been limited to basic services such as building maintenance. As outlined above, the pressure to restructure has until now been limited. But since the recent banking crisis at least, professional sourcing has reached board level. With the announcement that it would outsource its IT, Deutsche Bank has proven a trendsetter, and other banks are watching closely. Nevertheless, outsourcing initiatives to date have been largely focused on IT infrastructure, maintenance, and development. The potential of professional sourcing remains in essence untapped. We believe that leveraging this potential will be a major driver of industry transformation and efficiency gains in the next decade. Different sourcing options will enable banks to align their capabilities rigorously to their chosen strategies and business models.

c) Breakup of the Value Chain

The question of "make or buy" has in the past not been a topic of interest in the industry banks have owned, and continue to own, almost the entire value chain, perhaps with the exception of building maintenance or other basic services. The financial services industry is probably the most integrated industry in the world. Today, we estimate that less than two percent of the global banking cost base is spent for outside services. In contrast, industries such as the automotive industry "make" as little as 25 percent themselves and "buy" about 75 percent from suppliers.[1]

But signs of value chain disintegration in banking are emerging. Globally, the annual outsourcing growth rate has been a breathtaking 50 percent since 1990. The number of intermediaries offering services is increasing rapidly. Transaction banks offer services to their holding companies, their industry associations' members, and other interested parties. Credit factories are on the rise. Auto banks and independent financial advisors are offering their distribution capabilities to product manufacturers.

As low-performing banks emulate the strategy of the high performers, the disintegration of the value chain will advance and change the makeup of the financial industry. To align their capabilities, banks will use sourcing options as a key instrument. Service providers, both those offering corporate-center-type functions and those offering services along the banking-specific value chain, will become attractive solutions for leveraging efficiency potential.

Let us close this section by pointing out that most German banks showed clear progress in "doing their homework" in 2003. In fact, they managed to increase their profitability by rigorously cutting costs, especially in personnel. Moreover, they have started to break up the value chain: Let us mention in this context only the spin-off of the real estate financing units of Commerzbank, Deutsche Bank, and Dresdner Bank by establishing the new Eurohypo, and the transfer of payments from Deutsche Bank and Dresdner Bank to Postbank. The capital market has already acknowledged these developments. Indeed, looking at total shareholder returns, German banks have clearly outperformed the German stock index DAX (26 percent) in the first ten months of 2003: Deutsche Bank (32 percent), HVB (53 percent), and Commerzbank (127 percent).

3. Going Forward

After defining your strategy and increasing your profitability, you have to identify the profitable segments and regions where you can grow: Growth is *the* value lever for outperforming the stock market, but if (and only if) your returns are above the cost of equity. With a clear business model and an efficient operating model, banks can focus on long-term growth, assured of avoiding value destruction and joining the value generators as they reap the rewards of higher market capitalization.

---

[1] In financial services, we look at insourcers' cumulative cost base and revenues, while in the automotive industry we assess the revenues of both automobile manufacturers and their suppliers. Thus, the figures are not directly comparable and are presented here for illustrative purposes only. For example, expenses for data suppliers such as Reuters or Bloomberg are here not included in the financial services outsourcing costs, though, strictly speaking, they are suppliers.

a) Organic Growth

Organic growth is defined by the internal growth of equity as opposed to M&A activity. Banks that focus on one of the six major levers of growth will reaffirm that banking can indeed be a growth industry. They will do this by selling as much as possible to their existing customers while simultaneously reducing customer attrition, especially among customers with the most value or potential value; by acquiring new customers from current markets and/or from expansion into new markets and thus improving the customer base; and by enhancing product and solution offerings and optimizing the selling engine.

The objective is to increase the share of wallet among existing customers by means of well designed and executed customer relationship management initiatives. In this context, investment in CRM infrastructure is essential (to put in place the basics for becoming a customer-driven organization). But this is only part of the solution, as CRM infrastructure, which typically consumes up to 80 percent of spending on these initiatives, usually is able to deliver only up to 20 percent of the benefits. The remaining 80 percent of the available benefits stem from non-IT components, including a motivated and capable sales force, better yield management, improved selling processes, insight-driven marketing, and campaign management. Bankinter is an excellent example of a bank that has put the whole package together and is now extracting the value of its investments. With 5.9 products per customer, it has demonstrated the ability to achieve a positive outcome from CRM initiatives.

In addition to these efforts, banks need to expand their existing customer base by acquiring new customers. Although this is much more difficult, it can be realized either by buying competitors, thereby gaining access to new segments, or by growing organically both in-market and in new markets.

Another important piece of the puzzle is the reduction of the customer attrition rate. Many banks have achieved dramatic reductions (up to 50 percent) in attrition with combinations of initiatives including customer loyalty programs, improved offers for specific segments, and improved customer service processes.

In mature markets, organic growth is hard work. The German banking market is also characterized by close relationships between customers and their so-called house banks. Nevertheless, we have witnessed a number of market entries in recent years, some of which are now highly successful operations. Independent financial advisors, auto banks, and customer specialists such as some direct banks have effectively gathered market share. The new entrants have built up and exploited their customer relationships, while big banks, in particular, have neglected classic deposit business to focus more strongly on high-end corporate, investment, and private banking. The rediscovery of core clients is now the number one imperative to improving organic growth.

b) Mergers and Acquisitions

The concentration of the banking industry is increasing dramatically, driven by the size of the largest players.

But M&A do not necessarily drive value creation. Cost and/or revenue synergies are generally overestimated and the bottom-line impact is often not sufficient to create

value by (over-)compensating the price paid for an acquisition. The right execution of post-merger integration makes the difference. Cost synergies can be realized especially in domestic mergers, but revenue synergies are harder to get here, and usually drive cross-border transactions. The German banking market is just starting its consolidation process, compared to other European countries where consolidation is now coming to an end.

Many banks reaped substantial rewards with cost cutting and domestic bank-on-bank mergers and acquisitions as stronger players acquired weaker ones within their markets. Synergies from M&A, along with cost reduction programs and advances in information technology, improved major bank efficiency ratios by about 150 basis points per annum between 1998 and 2001. But this path to external growth cannot continue. The conditions that fueled growth in shareholder value in the 1990s have shifted, with banks now operating in uncertain economic, political, and competitive environments. Domestic bank-on-bank M&A as a driver of shareholder value is nearing its limit in many markets. The reasons are twofold: first are the antitrust regulations, and second, cost-takeout opportunities are decreasing. In many countries, more consolidation would trigger business or political resistance to the reduction in domestic competition. While opportunities for in-market M&A are drying up, the alternative of cross-border acquisitions is not as readily attractive. This is because traditional cost-takeout opportunities are here generally no more than five percent and often close to zero. The efficiency barriers to operating across borders include distance; differences in language, culture, currency, and regulatory/supervisory structures; and explicit or implicit rules against foreign competitors. The evidence in different geographies is consistent with the hypothesis that these barriers offset most of any potential efficiency gains from cross-border consolidation.

The past evidence on the benefits of achieving profitability via mergers and acquisitions is mixed. Industry research has found that over 70 percent of mergers and acquisitions actually destroy value. Focused mergers—mergers of players in the same geographical location and with roughly the same activities—tend generally to create more value, whereas unfocused mergers tend to destroy it. Exceptions are mergers between banks and insurers, which have created value in many cases.
Characteristics of successful acquisitions include

- a clear CEO-level strategy and value-driven leadership perspectives and frameworks to guide dealmaking and integration
- a clear distinction between cost synergies and revenue synergies and a clear path to the realization of bottom-line impact
- a focus on moving quickly in areas relevant to the merger's key value drivers (e.g., customers, channels, products, and services) while showing patience in others
- „world-class" M&A integration capability (organization, infrastructure, methods, tools, and skills).

Reasons for unsuccessful M&A are poor strategy fit, no shared vision, exclusive focus on cost savings, inadequate due diligence/integration planning, cultural mismatch,

lack of management commitment, failure to retain the best customers, inability to execute with certainty and speed, resistance to new behavior, and poor communication.

III. Summary

After the hype, most banks were unprepared for the crash in 2000. But a few of them not only survived without major damage, but even managed to increase market share during the so-called banking crisis simply by buying their relatively weak competitors. In fact, two strategies have proven superior:

- Achieving size and scale in the global market in order to provide full banking service
- Focusing completely on one business segment in order to provide either highly specialized know-how or standardized processes

Choosing one of these strategies and following it stringently in the future is the first and most important of the three steps to sustainable value creation. Second, you need to improve profitability in the segments that do not earn their respective cost of equity, if necessary by downsizing them. To improve profitability, you need the basic techniques for successful performance: 1. Reduce risk and loan losses or price accordingly using superior risk management tools, 2. Industrialize processes by increasing automation, process efficiency, and professional sourcing, and 3. Break up the value chain. The final step is to grow by expanding all profitable segments to the greatest degree possible. The use of external growth opportunities in the form of mergers and acquisitions influences value creation and should be carefully executed in line with the chosen strategy. Positive change with this three-step plan is measured in better economic results. And higher value added is the key driver for superior stock market performance.

Finally, it is worth pointing out that after German banks have completed the steps for value creation described above, they will have to compete with their European peers. This will not be easy: The consolidation process is just beginning, and margin pressure in Germany remains high because of the banking sector's structural disadvantages, but business profitability has to increase further. The market holds huge value potential, and the winners will be the banks that ensure excellence from strategy to execution, managing efficiency and growth within the frameworks of their chosen strategies and business models. First successful steps of the major German banks could be observed within the first ten months of 2003, already reflected by an impressive increase of stock market values since January.

Strategic Options in Banking

Hans-Jörg Rudloff

Well, the one thing, Ladies and Gentlemen, I am not going to do is to bring additional advice from London to the German banking establishment. I think that you get your full dose day by day from my colleagues, from the newspapers, from the television and so forth, and I think that everyone has already solved your problems with the exception of yourselves. But you should take some encouragement, because don't forget that the famous efficient international market in London was not built by the Anglo-Saxon institutions but on the contrary, by European ones and the famous offshore euro-market flourished under foreign institutions with very little participation from the UK side. And as you know, when Mrs Thatcher thought it was useful to merge the domestic market with the international side, it was an exit for all English merchant banks to sell as rapidly as possible to foreign institutions. And that's where they stand today. Now, when I say I don't want to bring any additional advice, I can offer only two or three observations. When the international capital markets were built, the institutional inertia was as great as it is today in other fields and things simply don't change over night. It takes a lot of patience, it takes of lot of courage and it takes a lot of people to speak up and to speak out in order to overcome the sometimes comfortable ways and means of how one is doing business. It takes your courage, it takes your ideas and it takes your actions to move things forward.

And anyone who thinks it is being done overnight should know that it's impossible. The cheap advice that you are getting always forgets that every country comes from a different background, has a different history, has a different system, has done things in a different way and in order to reconcile all these differences it would be foolish to think that it could be done in a few years.

I think Europe, or the financial system in Europe is still a huge construction site, which leaves a lot of unfinished business in the banking system. This unfinished business is different from country to country. Some countries have done their domestic consolidation or at least are far down the road on their domestic consolidation, others are lagging behind for reasons, which rarely have anything to do with what the banks would like to do but with their general framework. Unfinished business, for example in Italy, anyone who watches, as a practitioner, the share prices of the Italian banks will come to the conclusion that that business will be finished pretty soon. Because when you see all

the related industrial groups busily buying the shares of the Italian banks in order to sit at the table when the consolidation will take place, knows that within one or two years enormous progress will be achieved. I have no doubt that the same thing will be the case here because there is outside pressure. The circumstances are very clear: the ones who finished their domestic consolidation will have been moving forward, some of the American banks and some of UK banks but as well particularly the French banks are making huge progress and are moving forward. Anyone who looks at the statistics today between the ten biggest banks by capitalisation and the next ten will already see huge differences, by any ratio you apply, whether it's return on capital, whether it is profitability, whether it is growth rate and therefore, it is very clear that for many institutions who have been held back by their environment, time is running out.

The question of what are the options? In reality, there are not many. There are very few. We all have our strategies, we all have departments who do nothing else than feed us day in and day out with papers, ideas, how to move forward, how to get better, how to acquire additional earnings, where to grow and how to improve our operations. But if you really think about it, there is only one big option. The option is to either become global or to stay regional.

The world is integrating very rapidly. Huge economic regions are being created. Obviously the biggest one in Europe. And even if it takes time, and even if sometimes integration hits obstacles, it is moving forward very rapidly. Every institution has to decide, do we want to go with the world, do we want to be part of it, do we want to participate or do we want to stay in our environment, stay a regional bank. And I could but I don't want to name the institutions that clearly have decided to stay behind, to be happy with what they do, to be regional, to become a converter in their own environment but do not want to grow with the world, do not want to defend their position, do not want to play a part in this rapidly integrating global village of the banking system. That's the big option that everyone has to take, which everyone has to decide upon. It's not easy to make these decisions, to move into other countries, to deploy into emerging markets. It takes courage to make these decisions, but there is no choice because size is extremely important.

If you earn, like Citibank, 1.3 bn dollars a month you can take different risks than institutions that earn 200 million dollars a month. You can deploy yourself around the world nevermind that it is risky to move into China or Russia or to go somewhere else. You do it with more conviction than if your own earnings base is not the one of your competitors. And I think size and scale is of enormous importance.

If you believe as I do that the number of clients counts most, you will also know that we will live, have to live with a new generation where the velocity of these clients will increase rapidly. Today a new generation is coming along and they are used to making choices, used to comparing and who will not stay, like maybe we and our parents, with the same bank forever. They will move around, they will look for their advantages. This is a huge challenge to our marketing skills, to our product lines, to our way of doing business and satisfying this huge clientele. And this once again is not an option, this is a

necessity. Because the ones who don't do it, will simply disappear as so many good old industrial companies have disappeared in the last ten or fifteen years.

So the options are limited. They are mostly geographical, they might be from time to time on the product line but for a big bank basically there is only one decision: Do I want to be part of an integrating, rapidly developing world where two, three billion people will become part of our system, will start to save, earn more money, need capital, or don't I want to be part of it, and stay in my region, stay a domestic bank, stay relatively small and will depend on the big ten, fifteen, twenty institutions which choose the other way. That in my opinion is the most important choice. Every bank will make its own decision as Mr Ackermann said before. It's easier to make that decision if you operate from a very strong earnings base, a sound balance sheet and good ratings than when you don't have that, when you still have to do a lot of repair work internally. That's why I can only urge everyone who thinks he is a little bit behind, time is running out. We have to move rapidly. America as you know is by far the biggest financial market in the world and must be between fifty/sixty per cent of all financial transaction volumes. And it is not a surprise, because if you analyse the characteristics of the big ten banks today, they are either American or have strong operations in America. And today, there are only one or two exceptions to that. They are all global, they are all moving towards the global size and I think the answers to all these big strategic options are very clear. In the interest of time I will stop right here. Thank you very much.

Summary by organizer of the Frankfurt European Banking Congress

Strategic Options in Banking

Martin Blessing

Well, I think there are a couple of options. But let me start with a definition or a description of where we stood two years ago. The German banking sector basically was in a difficult situation and, of course, Commerzbank was no exception. And I think Mr. Ackermann mentioned that the first step in a strategy is to do your homework and I think that's exactly right. We basically have done our homework in the first phase, that is major restructuring and improvement of the operational performance. Let me give you an example: if you look at our private customers division, we made a loss of roughly 250 million euros two years ago; this year we will probably make roughly the same amount in profit. So we have a swing of 500 million in two years. I think that is a good example that you can do restructuring in Germany and that you can do it much faster and much harder than many people used to believe a couple of years ago.

The second thing you have to do is to clean up your balance sheet and see what the problems might be in the balance sheet. I think there is no additional explanation needed by Commerzbank that we have done our job there.

But what happens after you have taken the restructuring step? You have to look for growth options again and you have to look in both areas where you are active, id. est corporate investment banking and also the retail banking business. And while in corporate banking a lot will happen with product expertise and there will be a continuing debate about cross-selling, you have all heard about this, I think an additional debate we will have is pure credit pricing. I think we will see also a period of increasing credit prices in Germany which are basically the results of a not very competitive position that the German market has internationally and we will see movement there which will be one of the revenue growth options of the future.

In the retail banking business, beside the ongoing debate about what the retirement system will do and how many new funds will come into the private saving systems, one of the biggest and most interesting debates, from my point of view, will be the question whether you are a distribution channel for your production facilities or you are basically in the end the buying agent for your customer. The latter means you have an open product platform where you do selections for your customer based on his need; and not based on the distribution needs of your own production facilities. I think that will happen and that with time will lead to interesting changes in the landscape of the business.

If you tackle these two growth options then of course we will have a third strategic question in Germany which was also mentioned, that is the question of consolidation, i.e. national consolidation and international consolidation. My point of view is that we should see first a wave of national consolidation. I think it is a bit shameful for the German economy that in one of the major sectors, id. est the financial sector, we are really not very well positioned in the international landscape. I think we have not done our homework in terms of consolidation there, so I see there will be changes in the future. Nothing specific, but I think we need to address this issue over time here in Germany because otherwise the role we can play in international consolidation is a diminished role which I think is not a favourable position to be in here in Germany. That's enough for a starting point.

Strategic Options in Banking

Horst Müller

Being the last panellist giving a statement I could cut it very short. Everything was said but not with my words.

Let me therefore take up what Mr. Ackermann has touched upon giving my biography. These are the two facts: one is that I am a manager of an insurance company and a bank. And the second is that I have a long-standing experience in HR.

Taking to the first one, yes, we want to become a leading integrated financial service provider at least in the retail segment in Germany. I think basically this is not a new strategy because you see similar movements in every European country under the name Bancassurance or the different combinations banks and insurances have chosen. But the real challenge is to really get integrated.

What are the starting points? I think Mr. Rudloff rightly has mentioned the number of clients. Allianz has in Germany more than 15 million clients, we at Dresdner Bank have between 5 and 6 million clients. Although there are some overlaps you could easily come to a good view that this is a very good starting point. But if you read what the banks should do, in the press and media every day, the answer to the problems the banks have is cutting domestic branch networks. Right, cutting costs, getting efficient, it's the right answer. But now combining the question how to get or to stay in close contact with your clients if you give up too many branches, one answer was web-banking. And my colleague Mr. Blessing can tell you much more out of his experience what that really means. Finally we will only touch a very small client segment with web-banking.

Another answer, and this is finally what we try to do, is taking advantage of the more than 12,000 insurance agencies we have all over Germany. I have to confess not every insurance agency is able to become a financial service provider but a lot of them are able if they are given the right means and the right products.

The second item is my experience as HR Manager in a bank. And if we take the experience we have had in the last few years one thing which is very specifically linked with Germany is co-determination. That does not mean that we are not able to cut costs, to get strategies through, but it takes a little bit more time. It is not much cheaper in

other countries around Europe but it takes more time. And this is something, I think, we should have in mind if we try to get a cross-border strategy at least in Europe. Thank you.

Euro Extension

Klaus-Peter Müller

Ladies and Gentlemen,

We have already considered the admission of ten new members to the European Union next May. Most of them will of course regard this as just the first step. In their view, integration into the European economic area will only have taken place when they are also using the single European currency.

Only euro extension – the title of our panel – will allow the best possible use to be made of the common potential for growth. As you know, not everyone in Europe sees it this way.

Some countries regard an independent monetary policy as the key element allowing them to respond flexibly to cyclical changes. In their view, this is the only way for monetary policy to support a growth-oriented economic policy, since it is based on the specific structure of the country in question.

Yet the euro is also having an impact on the countries that have rejected it. The conflict of goals in an economic area dominated by the euro is a special challenge to the central banks.

So I am pleased to be able to welcome four central bank governors to our panel today. The points raised above are of course all part of their daily business:

Jean-Claude Trichet, President of the European Central Bank, will be accompanying the new EU members into the euro area, so to speak, and is responsible for ensuring continuity in the monetary policy then pursued. In addition, the stability pact and a policy of reform still need a committed advocate.

I also welcome Lars Heikensten, Governor of the Swedish Central Bank. Given the unmistakable outcome of the recent euro referendum, Sweden's position vis-à-vis the other central banks in the euro area is bound to change. Moreover, there is a danger of Sweden having less of a say in fiscal and economic decisions within Europe. The Swedish Central Bank's assessment of its country's outlook will no doubt also interest the new EU members. At this point, may I remind you that two years ago Sweden's

foreign minister Anna Lindh was with us here. Her murder has robbed the Swedish people of an able and popular politician, and we have all lost a true friend of Europe.

Ladies and Gentlemen, the President of the Swiss Central Bank, Jean-Pierre Roth, will be giving us the viewpoint of an independent country surrounded by Emu members. The euro may in fact be affecting the Swiss economy to a greater extent than is desirable for a really independent monetary policy.

Zdeněk Tůma, Governor of the Czech Central Bank, will explain how much the arguments already mentioned have affected – and will affect – the country's strategy enroute to the euro area. Incidentally, it is interesting to note that the government of the Czech Republic is rather more reticent about EMU than, for example, Poland. No doubt the Czech Central Bank will have played a role in shaping this standpoint, which is geared first and foremost to fiscal consolidation.

Before we start our discussion, let me throw out three ideas that we can follow as we are talking:

1. Nothing so far has made European integration seem as real as the introduction of euro cash at the same time in 12 countries at the start of 2001. But all the parties involved – governments, businesses and pressure groups – still need to adopt a more active response to the greater competition now prevailing within EMU if the necessary momentum is to be developed.
2. The euro alone is not enough to bring about an integrated, efficient economic area. An innovative, growth-oriented approach is needed to abolish restrictive government regulations.
3. The central banks are not only responsible for ensuring price stability, but also have to influence economic decisions to check uncoordinated budgeting involving large deficits.

Euro Extension

Lars Heikensten

The outcome of Sweden's referendum was an unambiguous „no" to euro adoption. This means business as usual for Swedish monetary policy. Since 1993 we have had an inflation target of 2 per cent, which has gained credibility with the public and the markets. Since the introduction of the inflation target, inflation has averaged 1.7 per cent while average growth has been 3 per cent. This compares well with Swedish experience in previous decades. It also compares favorably with the recent performance of the euro area. This relative strength of the Swedish economy was in my opinion an important factor behind the result in the referendum.

However, the outcome of the referendum does not mean business as usual in our relations vis-à-vis the rest of Europe. We will not have a seat at some of the negotiating tables in Frankfurt and Brussels that we could have had. Of course, we will try to compensate for this. To some extent, this can be done by keeping our own house in order - by conducting sound economic policies. Also, we will do our utmost to contribute to European policy discussions. Being outside the euro certainly doesn't mean that we want to be on the margins of the debate on monetary integration in Europe.

Sweden remains a 'pre-in'; we will have to consider euro adoption again at some point in the future. Therefore the evolution and enlargement of the euro area concerns us. Secondly, Sweden is probably one of the EU nations that will benefit most from the enlargement of the European Union. Our economy is one of the EU's most integrated with acceding countries, with surging East-West trade and FDI. Also, should Estonia, Latvia and Lithuania adopt the euro, we would be directly affected because Swedish banks own most of the Baltic banking system.

I would therefore like to share some reflections with you on two subjects of relevance to euro area enlargement: the risks associated with exchange rate mechanism (ERM II) membership and long-term frameworks for fiscal policy.

However, before this let me stress two things:

First, the long-term advantages of euro area enlargement are evident. I believe the advantages would be roughly the same for acceding countries as they would be for Sweden: integration of trade and capital markets stimulates growth for both the euro adopter and the euro area. In the case of acceding countries, there are probably additional advantages of monetary integration; it gives added stability after the difficult years of transition and is important for their less developed financial sectors. So the issue is not really euro area enlargement as such, but rather its timing and preconditions.

Second, from the perspective of the euro area itself it is hard to see how acceding countries could pose any major risks to price stability. The sum of the economies of all the new member states does not presently amount to more than the GDP of the Netherlands. Furthermore, historically high inflation rates in the acceding countries have been reduced through reinforced macroeconomic discipline (which in turn owes much to the enlargement process). A simple calculation shows that even if growth in the acceding countries averages some 4 per cent more than the euro area, and this catch-up, according to most estimates, generates Balassa-Samuelson price convergence with 2-3 percentage points higher inflation than euro economies, their inclusion in the euro area would still only add some 0.2 percentage points to area-wide inflation. Instead, it is the perspective of the acceding countries themselves that is crucial.

Risks with ERM II

In order to enter monetary union, countries must first participate in the exchange rate mechanism (ERM II). The one risk with ERM II that has been discussed at length in recent years is the potential conflict between a pegged exchange rate and an inflation target. Both exchange rate stability and low inflation are necessary to fulfil the convergence criteria, but in some cases it may be difficult for monetary policy alone to meet two targets at the same time.

One possible situation is that the central parity has been set too low and that real appreciation pressures, due to catching up, are so strong that the upper band comes into question. This can result in large-scale speculative currency flows and unnecessary turbulence, as demonstrated by the attack on the forint at the beginning of this year.

The obvious solution to speculation against the upper band is to reach an agreement in ERM II to revalue. But this is often difficult in practice. When political decision-makers are forced to choose between the inflation and exchange rate targets, it takes courage – and good analysis – to give priority to low inflation and opt for revaluation. As the case of Ireland has demonstrated, this does not exclusively apply to acceding countries. In the end, the result can be inflationary pressures once inside the euro area.

However, the most acute risk with ERM II is probably when the exchange rate is in the lower part of the band. Virtually all the currency crises that we have experienced in recent decades have been due to speculation against weak currencies. ERM II, of course, is different from these previous failed regimes of pegged exchange rates in the sense that it has a clear exit strategy with regard to euro adoption. But this does not mean that ERM II is immune to large fluctuations in short-term financial flows.

I do not think this should be a big problem for the currency board regimes or the so-called hard pegs in the new Baltic member states. In their case, ERM II membership would merely be confirmation of a credible regime that has been successfully maintained for nearly a decade, even when confronted with severe shocks such as the Russian crisis. This has been possible thanks to a high degree of wage flexibility as well as serious efforts to achieve fiscal consolidation.

There is more reason for concern over some of the presently floating regimes as they move towards ERM II. Substantial fiscal slippages have occurred in some of these countries, bringing them far from the 3 per cent deficit requirement. In most cases the deterioration has not been a consequence of additional costs related to accession; neither has it mainly been the result of automatic stabilisers – these are considerably smaller in acceding countries than in present EU members. Instead, the large - cyclically adjusted - deficits reflect increases in public wages and so-called mandatory social spending, combined with a lack of expenditure cuts in other fields. Consolidation is planned to take place mainly in the medium to long term, and deficits are only set to be reduced to levels compatible with the convergence criteria towards the end of the decade.

Some of my central bank colleagues from the new member states argue that rapid entry into ERM II and the target of an early euro adoption is precisely what will force politicians in their respective countries to improve fiscal policy. In the words of one of my most eminent colleagues: „delay in entry equals delay in reforms”. Of course, I can understand this argument, and in the end it hinges on the political economy of each country. But using ERM II as a straightjacket is a risky strategy. It is all too reminiscent of the 1990-92 period in Sweden when the „nominal anchor” of the ECU peg was supposed to „bind us to the mast” but ended in a macroeconomic shipwreck. A botched entry into ERM II, with increasing public deficits, will be prone to economic and political instability. Furthermore, if meeting the convergence criteria is viewed as the main leverage for fiscal reform, it is worth remembering that this particular leverage disappears on EMU entry.

A framework for fiscal policy

This brings me to my next topic: fiscal policy frameworks for countries in the currency union. This is an important issue, partly for the stability of the union as a whole. It is also the perspective behind the Stability and Growth Pact. But strong frameworks for public finances are also important for each individual country when they no longer have an independent monetary policy. Only if fiscal policy is in order can asymmetric shocks be dealt with in a reasonable way.

The risk of asymmetric shocks is not necessarily higher in the acceding countries than in many of the present member states; in some cases it might even be smaller. A number of studies point to a relatively strong correlation in acceding countries with the business cycle of the euro area. However, it would be unwise to assume that no important asymmetric shocks relative to the rest of the euro area cycle will ever occur. Also, there are risks of domestically generated „political" shocks due to policy mistakes. We have had examples of this in Sweden and it could also happen in some other countries.

How can euro adopters prepare public finances for asymmetric shocks? This was a major issue in the Swedish debate ahead of the euro referendum. Despite the fact that there had been reforms in the public-finance framework in Sweden in the 1990s, the Riksbank and others argued that more should be done before joining the euro area.

Essentially two things are required:

First, there is a need for sufficient margins in the public finances. In practice, this means that debt levels should not be too high. If the economy enters a downturn that does not affect the rest of the euro area to the same extent, it is important that there is scope to conduct a more expansionary policy. If the scope is there, one can be reasonably sure that it will be used.

It is more difficult to handle the second, opposite situation - upturns and over-heating tendencies. What is then required is a framework that encourages or even forces political decision-makers to act in time and take decisions that might be difficult in the short run but that are correct in a longer-term perspective. Here some inspiration can be drawn from Swedish monetary policy set-up. Fiscal policy could be guided by clear targets that are defined in terms of countries' output gaps. Alternatively, national inflation targets could be introduced. In combination with transparent processes, including recurrent evaluations by national parliaments or in other arenas, this could put pressure on politicians to act.

Is the Stability and Growth Pact not sufficient in itself? After all, it is designed to ensure fiscal discipline in the member countries. Clearly, it could have been supportive if it had only been followed. But now the situation is different. As the Pact has not been followed by the larger euro area countries, there is a risk that the newcomers will take the same attitude when in fact they would be wiser to look at the issue the other way round. Both Germany and France previously attained the 3 per cent mark for the public deficit criterion by too narrow a margin despite what was a global upturn. Then they clearly did not do enough afterwards in terms of consolidation, despite intense pressure from many of the smaller countries. Today, this is a significant problem, not only for the euro area as a whole; the countries themselves are also paying the price in terms of a deeper and longer downturn. This, if anything, is a warning to new euro adopters.

Conclusions

Having raised these complex issues, let me be very clear about my sentiments. I do not wish to see any new obstacles or separate rules for the new member states; equal treatment is essential. No other rules for convergence should apply to the new euro adopters than those that have applied to present euro area participants or that would have applied to Sweden if we had voted „yes" to adopting the euro. Indeed, early euro adoption may be entirely beneficial for those new member states that have sufficiently stable and flexible economies and that have followed a course of fiscal prudence for a long time, just as I personally would have considered it beneficial for Sweden had we joined in 2006.

Rather, it is in the euro adopters' own interests to independently consider the risks. Countries that have used exchange rate flexibility should not rush into a system of fixed exchange rates before the conditions are right. If you have not already achieved fiscal discipline, do not enter ERM II nor opt for early euro adoption as leverage on politicians to bring about such discipline. It is not only a matter of meeting the 3 per cent convergence criterion but also of reaching a maturity in fiscal policy that includes a transparent and predictable fiscal framework with sufficient room for maneuver for stabilisation policy. The road to the euro may otherwise become very rocky, and if the euro is eventually adopted, the trade-off between fiscal rectitude and stabilisation needs may become a recurring problem.

My advice would be to put your house in order first, and only after that enter ERM II and begin a quick process of euro adoption. Then you will have the best possible guarantee to reap the full benefits of monetary union.

Thank you.

Euro Extension

Jean-Pierre Roth

Thank you for giving me the opportunity to express here my views on the experience of Switzerland at the center of the Euro-zone.

The introduction of the euro back in 1999 has drastically changed Switzerland's environment. Our country is now fully surrounded by the euro area. Switzerland looks like an island in the middle of the euro ocean. But rest assured, we have had no difficulties in keeping our feet dry, and as we have shown recently, we have made impressive progress in sailing.

It is well known that a monetary union brings many benefits to its members. Transaction costs are sharply reduced. Exchange-rate volatility and uncertainty vanish within the currency area. Price comparisons are facilitated and overall transparency is enhanced. All this means that trade and capital flows between the participating states are invigorated, which should bring about more growth and less unemployment.

Naturally, monetary integration has its costs, too. The most important among them is the loss of monetary sovereignty. This causes no deep regret in countries where the central bank had difficulties in preserving price stability in the past, but in other countries a single monetary policy along the lines of "one size fits all" is regarded differently. It can lead to problems in specific situations. Under monetary union, adjustments that would otherwise occur through changes in the exchange-rate and in domestic interest-rates must imperatively take place through changes in prices and wages, and through structural adjustment, all of which can be very painful. Some of the difficulties faced by the German economy in the recent past can be explained by the absence of monetary autonomy.

There is no question that Switzerland also benefits from the existence of the euro. It makes life much easier for all of us who travel and do business in Europe. We all profit from lower transaction costs, greater certainty, transparency and stability. Moreover, for us at the Swiss National Bank, the single currency has made our job somewhat easier since we are now surrounded by countries that all share our concern for price stability.

Since monetary integration appears to be such a good idea, why doesn't Switzerland join in as well? Adopting the euro is not an option for us since we are not part of the European Union. But wouldn't it be conceivable for Switzerland to tie the Swiss franc to the euro, thus effectively adopting a fixed exchange-rate regime? Many argue that

the movements of the franc against the euro are undermining the Swiss export industry and that, if left uncontrolled, could generate unemployment problems.

Unfortunately, things are not as simple as that. As European experience shows, fixed exchange-rate regimes are arrangements that never last for a very long time. Moreover, they have a habit of collapsing at the worst possible moment, usually in an environment of crises and confusion. More importantly, as is well known, monetary policy has no hold on real variables in the long run. The real exchange rate, which is decisive for decisions about production and trade flows, cannot be manipulated by monetary policy for any length of time.

In the case of Switzerland even more seriously a fixed exchange rate between the franc and the euro would cause nominal Swiss interest rates to rise to the same level as interest rates in the euro zone. This would mean that our country would lose the advantage of lower interest rates, which at present are 150 bp below Euro levels. The user cost of capital would increase even though labor costs would remain unchanged. This would put additional pressure on the competitiveness of our economy. Such a rise in the general level of interest rates would also lead to a drop in asset prices and depress aggregate demand. Since the Swiss National Bank would no longer be able to conduct an independent monetary policy, we could do nothing about such developments. It is easy to see that for our country this would be a high price to pay for the illusion of exchange rate stability and preserved competitiveness.

The years since the introduction of the euro have demonstrated that the Swiss National Bank is perfectly able to conduct an independent monetary policy in the euro environment. Our policy actions were often taken well in advance of similar moves by the European Central Bank. Thus, when the Swiss economy came to a standstill over the past two years, we were able to move very aggressively, lowering short-term interest rates from 3.50% to 0.25%. As for our goal of price stability, by which we mean an inflation rate of less than 2%, we have achieved it for ten years running.

In conclusion, the Swiss franc has not been destabilized by the introduction of the euro. It remains attractive and an important asset for the Swiss economy. We enjoy price stability and a lower interest rate level than our neighbours. We do not expect the coming enlargement of the European Union to change this situation.

As you see, Switzerland benefits in many ways from the uniformity, the transparency and the more stable European monetary environment brought about by the single currency. While the risks of excessive exchange rate fluctuations between the franc and the euro appear to be manageable, we enjoy many advantages of the monetary integration and can maintain enough freedom in our interest rate policy to meet the needs of our economy.

We all benefit from the introduction of the euro, but for Switzerland the balance between the advantages and disadvantages of being an outsider is still positive.

Euro Extension

Jean-Claude Trichet

First of all, when I look at the three countries and economies that are members of the EU and are not yet members of the euro zone, I am struck by how the case-by-case examination is justified. We have the United Kingdom, which has an opt-out clause and has not yet decided to join, even if everybody knows that the United Kingdom is welcome in the euro zone. We have Sweden, which has no opt-out clause and so is in a totally different legal position to the United Kingdom: a situation which, as just explained, means they haven't joined the euro area. And we have Denmark, which has an opt-out clause. Denmark is not in the euro area, but is very closely associated with the euro area: it follows all the policy measures that are decided within the euro area and it is an exemplary member of ERM II. So we have three EU Member States that are not in the euro zone, and three different cases from the legal analytical and practical standpoints. And that means that the newcomers – which is our main subject this afternoon – should also have in mind that the case-by-case examination, looking at the very practical nature of each country, will be done very carefully. It will, of course, be carried out by the governments and central banks at stake and also by the ECB and the euro zone.

I would like to discuss three main issues: general principles, the Exchange Rate Mechanism II and the question of the adoption of the euro.

On the general principles I have three remarks. First, all the acceding countries will join the European Union as Member States with a derogation, which means that they don't have an opt-out clause. They are in the same situation as Sweden: while not yet adopting the euro, they will be committed to strive towards the eventual adoption of the euro once they fulfil the convergence criteria laid down in the Treaty. This is very important in legal terms because we have to know the legal position of all the new Member States. Second, the acceding countries differ greatly in terms of their economic structure, exchange rate and monetary regimes, and the degree of nominal and real convergence already achieved. You have said, Governor, that the difference between nominal and real is not as big as some suggest. For us it's very simple: nominal refers to a "snapshot" of the situation, real means sustainable nominal convergence. This is in the Treaty, of course, and it is important that it is sustainable. But as we have to cope with very different situations, no single path towards ERM II and the adoption of the euro can be

identified and recommended. We have to recognise also that there was no single path for the current members of the euro zone either. We also have different cases with the 15 Member States of the European Union. Therefore, the Governing Council of the ECB thinks very strongly that the individual country situations and strategies have to be assessed on a case-by-case basis throughout the process leading to the euro.

Third, an issue which is important for some countries: we consider that any unilateral adoption of the single currency by means of "euroisation" outside the Treaty framework runs counter to the economic reasoning underlying EMU in the Treaty. The Treaty foresees the eventual adoption of the euro as the endpoint of a structural convergence process. Therefore, within a multilateral framework, unilateral euroisation cannot, in the Governing Council's view, be a way of circumventing the stages that are foreseen by the Treaty for the adoption of the euro.

Now let me turn to the Exchange Rate Mechanism II. I have five, short remarks. First, on the main features, I will simply remind you what the Treaty says; namely that ERM II is a multilateral arrangement of fixed, but adjustable, exchange rates with a central rate and a standard fluctuation band of ±15%. Economic policies of the participating members in ERM II must be consistent with the preservation of the central rate and thus strive to avoid misalignments. Interventions on the margins will, in principle, be automatic unless they were to conflict with the primary objective of price stability.

Second, the Governing Council of the ECB considers that ERM II can accommodate a number of exchange rate strategies currently adopted by acceding countries. I will not remake the point on euroisation. But of course the only incompatibilities with ERM II, apart from euroisation, are the cases of free floating, of floats without a mutually agreed central rate, crawling pegs and pegs against anchors other than the euro. With regard to currency boards, the ECB does not consider them to be a substitute for ERM II participation, but we consider that countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift: first, abandoning the currency board and the floating of the currency within ERM II, and then repegging it to the euro and entering the euro at a later stage. It would be possible that such countries could participate in ERM II with a currency board as a unilateral commitment enhancing the discipline within ERM II. However, the ECB stresses that such an arrangement will be assessed on a case-by-case basis and that, in any case, common accord is necessary and will have to be reached on this regime and, of course, on the central parity.

Third, as regards entry into ERM II, I reiterate a point that was alluded to by yourself, Governor. In our view, entry into ERM II is not subject to a set of pre-established criteria and there are no a priori conditions to be fulfilled. However, to ensure smooth participation in ERM II it is necessary, in our view, that major policy adjustments – for example, as regards price liberalisation, fiscal policy etc. – are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is followed. Moreover, as with any exchange rate regime, participation in ERM II is only one element of the overall policy framework and, hence, should not be regarded in isolation.

It must be compatible with the other elements of the overall policy framework, in particular with the monetary, fiscal and structural policies.

Fourth, the length of participation in ERM II. Beyond the minimum period of membership of the two years prior to the convergence assessment before entering the euro, there are no restrictions on the length of stay in ERM II for new Member States. Although all new Member States are ultimately expected to join the euro, no timetable is foreseen. Therefore the length of participation in ERM II should be assessed in terms of what is most helpful to accompany the convergence process, rather than in terms of the required minimum period of two years.

Fifth, we really believe that, given the risks implied in premature rigidity of the exchange rate, it might be appropriate for some of the new Member States, to consider application for ERM II participation only after a further degree of convergence has been achieved. I think we probably are in agreement on this and, again, we call for examination on a case-by-case basis. This is particularly advisable when early rigidity of the exchange rate could precipitate disorderly realignments with potentially disruptive economic consequences, including for the credibility of the mechanism as a whole. For other new Member States that have implemented significant structural reforms and have shown the ability to advance convergence through sound economic policies and an exchange rate regime compatible with ERM II, entry into the mechanism can take place soon after accession. We don't exclude that at all, provided that there is mutual agreement on both entry and the central parity. But in certain cases – again I think this consideration is very important – new Member States may consider it desirable to envisage a longer stay in ERM II while further convergence takes place.

Finally, a few remarks on the adoption of the euro itself. The Governing Council stresses that assessment on the entry into the euro should, and must, be based on the Treaty provisions and must ensure equal treatment with the current Member States. Therefore, there is no additional criterion for the new Member States, nor will there be any relaxation of the criteria laid down in the Treaty, including the criteria on the sustainability of the nominal convergence, namely the criteria of real convergence.

With regard to exchange rate stability, the criterion is participation in ERM II for a period of at least the two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro. The assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate, while also taking account of factors that may have led to an appreciation in line with what we did in the past. In this respect, the width of the fluctuation band within ERM II shall not prejudge the assessment on the exchange rate stability criterion. Moreover, assessing the absence of severe tensions is generally addressed i) by examining the degree of deviation of exchange rates on the central parity against the euro, ii) by using such indicators as short-term interest rate differentials vis-à-vis the euro area and their evolution and, iii) of course, by considering the role played by foreign exchange interventions. That is the position of the ECB's Governing Council.

So to conclude, on top of all those considerations which are really of the essence, as all other speakers have said, what counts above all are the fundamentals: the policies

that we are all pursuing, the monetary policy and the economic policies. Success is only guaranteed if we have good fundamentals. And this we must always keep in mind.

Summary by the organizer of the Frankfurt European Banking Congress

Euro Extension

Zdeněk Tůma

Ladies and Gentlemen, dear Colleagues,

In May of 2004 we will experience an enlargement of the European Union which in many respects will be different from previous ones. First, the number of acceding countries is unprecedented, which requires deeper thought about the decision-making mechanisms at the EU institutions. Second, the economic level of the new EU countries will be much lower on average, even compared with the least developed present members, implying stronger challenges for long-run convergence than ever before. Third, the accession countries are entering the EU after the creation of the monetary union, which means that immediately upon EU accession the policy focus will shift towards future adoption of the euro, which may come quite soon in some cases.

Time has thus become very pressing. The earlier theoretical debates on what challenges might be associated with accession to the EU – and later on the EMU – have now shifted towards the practical level of finding how best to cope with these challenges. In many respects, the academic – and usually open-ended – discussions of the pros and cons of the integration process now need to be replaced by action. Let me focus on the field that is most important to me as a central banker: Euro-zone enlargement.

Many accession countries, including the Czech Republic, have already published their EMU accession strategies, or are about to do so in the near future. In these strategies, we have had to address in a pragmatic way the economic and political issues that characterised the earlier debates.

One issue that we have had to cope with has been the uncertainty surrounding the position of the EU's institutions on the speed of Euro-zone enlargement and the interpretation of the rules. We have heard many general comments on the benefits of the ERM II system. It has been argued that this regime is a useful monetary policy framework that can have a disciplining impact on domestic policies, limit exchange rate volatility, and help determine the conversion rate for EMU entry, yet at the same time provides enough flexibility. There is no doubt a valid point in all these arguments. Yet it does not mean that the ERM II is better than other monetary policy frameworks. It also has its weaknesses. That is why – on the practical level – the question is not whether to enter the ERM II, but rather how to minimise its risks by choosing the appropriate tim-

ing, suitable central parity, supportive policy mix, etc. To do this, we need to be given a clear interpretation of how the exchange rate criterion will be assessed.

Similarly, we have heard many general comments on the optimal speed of euro adoption, usually cautioning against a fast-track approach. Such universal statements necessarily ignore many country-specific circumstances, such as the current economic situation, monetary policy regime and fiscal stance. In this respect, the accession countries can be divided in two broad groups. First, there are the countries with pegged exchange rates, for example currency boards with the euro serving as the anchor currency. I can see no reason why countries with a hard peg to the euro which have proven their ability to live without their own monetary policies without severe tensions should be cautioned against fast eurozone entry. In their case, accession is clearly beneficial, as it reduces the residual risks at no apparent cost. On the other hand, the roadmap to the EMU might be completely different for the countries with floating exchange rates and inflation targeting regimes.

The general nature of the earlier debates is partly understandable. In the previous period, the political and analytical focus was on EU accession in both the EU and the accession countries, while eurozone enlargement seemed to be in the distant future and thus not an imminent priority. Now, though, our debates have shifted to a more advanced level. Interpretations have been given by the EU institutions on the convergence criteria and, most importantly, the exchange rate stability criterion. These interpretations will no doubt be the subject of further policy discussions in the near future. At the same time, a broader consensus seems to have emerged that there is no universal prescription for all the accession countries regarding euro adoption.

Other debates have also shifted to a more pragmatic level. For example, the potential trade-off between the real and nominal convergence processes received particular attention in the earlier academic discussions. It was questioned whether the accession countries can simultaneously achieve low inflation, nominal exchange rate stability, consolidated public budgets and sufficiently fast economic growth. It was often argued that economic growth should be given priority at the current stage, and only later on should the nominal convergence goals be pursued more vigorously.

It is true that the current level of GDP in most accession countries is well below the EU average. But we should avoid oversimplified conclusions. First of all, even in this respect one can distinguish between two groups of countries. On the one hand, GDP in PPP in the more advanced accession countries varies between 50% of the EU average (for Slovakia and Hungary) to 70% (for Slovenia) or even higher (Cyprus). On the other hand, there are countries with GDP at or below 40% of the EU level, including Poland and the Baltic States. If one wanted to tie the accession date strictly to GDP, the recommendation would have to be different for those two groups, ruling in favour of the former. Paradoxically, though, it has mostly been countries from the latter group, id. est the Baltic States, which have so far demonstrated their ability to achieve real convergence simultaneously with low inflation and consolidated budgets, without having independent monetary policies. These countries are among the prospective early entrants, regardless of their GDPs.

Second, if we wanted to condition eurozone entry on GDP, it is clear that the enlargement would be postponed for decades rather than years. For me, this would mean a radical change in the rules. So far, euro adoption has been linked to EU accession, as the new entrants have been given no opt-out clause from the monetary union. Postponing euro adoption for decades would be tantamount to such an opt-out clause, in my opinion. And nobody has openly set their sights on such a solution. The focus should thus be put on cyclical and structural convergence as important OCA criteria, rather than on the absolute GDP level.

Third, at this stage of the debate it is also necessary to be quantitative, rather than qualitative, in discussing the implications of the real convergence process for monetary policies and EMU enlargement. In my opinion, the potential conflict between real and nominal convergence has quite often been exaggerated. There are certainly links between the two convergence processes. For example, fast disinflation through tough monetary policy would be connected with a temporary growth slowdown. It is also true that faster potential GDP growth is likely to lead to real exchange rate appreciation, making it impossible to have both very low inflation and a completely stable nominal exchange rate. Nevertheless, my position is that the two processes are not quantitatively incompatible, and moreover, they have different time horizons. Nominal convergence is achievable in the medium run, while real convergence remains a long-term matter.

Most of the accession countries have achieved impressive results with nominal convergence. They now enjoy moderate, or even very low, inflation rates, and their nominal interest rates have converged to the EU levels. In the majority of cases, no practical problems with meeting the Maastricht criteria on inflation and long-term interest rates are envisaged. Moreover, this progress has often been achieved simultaneously with satisfactory growth performance. Admittedly, some countries have gone through economic recessions that have helped them with disinflation, but these were usually reactions to previous macroeconomic and structural imbalances in their economies rather than the consequences of overly ambitious anti-inflationary policies.

As far as real appreciation is concerned, most of the accession countries have exhibited a clear trend towards real exchange rate strengthening over recent years. Moreover, in many cases – including the Czech Republic – its pace has been fairly high, more so than can be readily explained by economic theory. However, we need quantitative analyses of its causes before we can make any policy judgements for the future. For example, the majority of the empirical studies of the Balassa–Samuelson effect have concluded that this hypothesis explains only 1–2 percentage points (or even less) a year of the real appreciation in the Central European countries. The rest must be explained by other factors, such as price deregulation, quality and terms-of-trade improvements, and structural changes in the economy. It is quite likely that these effects will become less important in the medium term, slowing down the equilibrium real appreciation. Therefore, real appreciation does not necessarily have to be a significant problem either in the ERM II or in the eurozone. In other words, the real appreciation might be modest enough not to pose a serious conflict with low inflation and satisfactory economic performance.

Another practical issue that we must acknowledge at this stage is that in many countries the practical constraint on the timing of eurozone accession is the public budget. The Baltic States are notable exceptions, but many other countries run large public deficits, even after one-off transition costs are subtracted. The necessary medium-term reforms include changing the public finance structure to address the ageing problem, overly generous social security systems, etc. These are problems shared by all European countries and are politically quite hard to resolve. It is thus not surprising that we have so far seen only the first – albeit very important – reform steps in many countries. These will need to be followed by further, more decisive measures, but a potential danger from delay exists. The consolidation of public budgets to a sustainable position is thus one of the crucial challenges for the accession countries (but also for many present EU members). The case for fiscal consolidation is further strengthened by the fact that upon EU accession the Stability and Growth Pact will become relevant to the new member states. This is something that has not been fully realised and appreciated yet, perhaps partly due to the absence of sanctions for the countries outside the eurozone. But an absence of sanctions should not be viewed as an excuse for not trying to achieve the Pact's objectives in the medium run.

Finally, I would like to stress that there are also practical issues to be addressed on the EU's side, including the future of the Stability and Growth Pact, further clarification of the convergence criteria, adjustment of the voting procedures at the ECB, and many others. The eurozone is still an infant institutional arrangement that needs further evolution. And the enlargement process should be viewed as a stimulus and catalyst for such changes, rather than as an obstacle to them.

Reforming Europe

Ernst Welteke

Delivering closing remarks at the end of an inspiring day is a curse and a blessing at thesame time. On the one hand, the final speaker faces the problem that everything has already been said. On the other hand, it is a feature of human nature to remember best what one heard last. I will try to exploit the latter by widening the perspective and commenting on a few overarching issues.

1. A Constitution for the European Union

A fully developed European identity is evolving only slowly. It may receive an additional boost from the European constitutional process. I am a strong proponent of the European Constitution. However, I have some objections to Articles concerning the foundations of European monetary union. The Constitution was drafted under a consensus that no changes of substance were to be made to the monetary framework. While the changes now envisaged look fairly small, they make a difference. As nobody can surely want to endanger the stability of the single currency, the Intergovernmental Conference must redraft the Articles in question so as to preserve the tried and tested status quo — if they decide to renegotiate the draft. I am well aware of the difficulties of reopening the negotiations, and especially of finalising them again.

I regard three issues as crucial:

a) Article I-3 of the draft Constitution mentions „balanced growth" as one of the objectives of the European Union, whereas the wording „non-inflationary growth" has been in the Treaty up to now. Price stability must not be dropped from the list of objectives of the EU.
b) The independence of the monetary authorities is a defining feature of European monetary union. Therefore, the Constitution must guarantee the independence not only of the ECB but also of the national central banks. Article I-29 of the draft must be amended accordingly. A second-rate independence of the national central banks, that is independence guaranteed by national laws only but not by the Constitution, is not acceptable.

c) The unique status of the ECB as an institution „sui generis" is given up in the draft Constitution. This reclassification may open the door to assigning objectives other than price stability to the ECB. The mere possibility of the ECB being forced to abandon its crystal-clear stability orientation might be a risk.

The members of the Intergovernmental Conference should be aware how the draft version would change the monetary framework of the Union — contrary to the consensus. In my view, redrafting the Convention's proposal in this respect is needed if the proposal is opened.

2. Transforming Eastern Europe

The drafting of a European Constitution comes at a time when the EU is preparing for the most challenging enlargement in its history. The reform process in the acceding countries will not be complete upon accession on May 1 st . The preparations for participation in European monetary union require further efforts. Their financial systems must be upgraded to the standard of the EMU countries. This is imperative in order to ensure smooth transmission of the single monetary policy in an enlarged monetary union. Furthermore, meeting the Maastricht criteria will require adjustments in fiscal policy. The political and economic transformation process which the central and east European countries have undergone is impressive. The notion of embracing the European political and economic model was basically undisputed. Right from the beginning it was seen as a golden opportunity, since it implied the prospect of freedom and prosperity. The prospect of joining the European Union is propelling political and economic reforms in the candidate state of Turkey. The reform process in Turkey is of a different kind, but in scope it is comparable to the transformation of the east European countries. Personally, I have the hope that the mere prospect of Turkey's joining the EU will contribute to a peaceful political stabilisation of the Middle East. The awful terrorist' attack have shown that this is urgently needed.

3. Reforming Western Europe

While reforms in Eastern Europe were perceived as „opportunities", Western Europe likes to discuss upcoming reforms in terms of losses. The West European countries, especially the three large countries, are in dire need of radical reforms. Strained public finances, persistent unemployment and ageing populations are putting the welfare state in its present form under pressure. The old ideal of providing social justice through a highly redistributive state is fading away. It simply did not live up to expectations. The role of the state is now being redefined as a more subsidiary one. The other side of the equation is that citizens are increasingly allowed – and expected – to manage their own affairs. Efficient markets and a proper set of incentives are reinforcing this trend. In short, today citizens row their own boat. And those who are unable to row their own boat can rely on the state for support. For a large part of Europe, this notion amounts to a minor revolution. As during the transformation process in eastern Eu-

rope, policy makers need to win people's hearts and minds for these reforms. We must learn to think [and argue] in terms of gains rather than in terms of losses. In this respect, policy makers in the EU countries can learn a thing or two from the transformation countries. What we need now is not a little bit of reform here and a little bit of reform there. Like the transformation countries had, we need a coherent approach to reforms. The Bundesbank mapped out such an approach for Germany in its paper „Ways out of the crisis" earlier this year. The German government's „agenda 2010" reflects the new approach to reforms. It should stick to this approach and must not allow itself to be deflected from its course. Let me comment in a little bit more detail on that. I would like to start with the fiscal side of reforms. Balanced budgets are at the top of the reform agenda. Public finances must be consolidated via the expenditure side. This is perfectly in line with the goal of a more subsidiary role of the state and should start with cutting subsidies. Past experience has also shown it to be the most effective road to achieving sound public finances.

Financial tensions in the social security systems are weighing heavily on budgets in the west European countries. For expenditure-side consolidation to work in an ageing society, the pension and healthcare systems must undergo a transformation. Partial privatisation and capital funding yield a triple dividend:

· they ease the burden on the budgets,
· they raise the systems' resilience to demographic stress,
· and they are perfectly in line with the model of citizens taking on greater personal responsibility.

The role of the state is changing. From being a provider of goods and services, it is beingtransformed into a facilitator which defines an overall framework designed to enable individuals to thrive on their own. This framework encompasses the market-based system: the labour market, the financial markets and the product markets. Flexibility is crucial for an efficient interplay of supply and demand.

The framework for a stability-oriented monetary policy has its fiscal equivalent in the Stability and Growth Pact. It was implemented in order to make sure monetary stability is not counteracted by fiscal leniency. The Pact itself is both sound and flexible.

The current unfavourable debt dynamics in the wake of slow growth bode ill for the single currency. In my view, it is imperative for the European member states — prominent among them, unfortunately, my own country — to stick to the sound fiscal policies required by the Stability and Growth Pact. I know from my own experience how difficult it is for a finance minister. He needs the support of all others in order to achieve his goal. The Stability and Growth Pact has been declared dead at about weekly intervals during this year. But remember Mark Twain, who commented on the news of his death „The reports of my death have been greatly exaggerated". The enforcement of the Pact must be ensured, and pressure must be raised to consolidate during economic expansions — and there is one in the offing right now!

4. Conclusion

What contribution can central banks make? In a nutshell, they can deliver price stability. European monetary union is designed to keep the price level stable and thereby to provide conditions conducive to employment and economic growth. Monetary policy in turn is facilitated by flexible markets. In an environment of flexible product and factor markets, interest rates can stay low for a longer time during an upturn. Strong demand does not necessarily translate into an increasing price level. So a credible stability-oriented monetary policy and flexible markets add up to a coherent framework for a dynamic economy.

At present, low interest rates and ample liquidity are highly conducive to growth in the euro area. In the ECB Governing Council we are ready to support the economic recovery as long as this is compatible with our mandate of maintaining price stability. The degree of confidence required for a self-sustaining recovery could be given a further boost by credibly promoting structural reforms in the west European countries.

On the eve of EU eastern enlargement, the west European countries are experiencing their own type of change. I welcome this development. It will bring about a shift in decision-making from the state to the individual.

The prospect of freedom and prosperity was the main driver of the transformation process of the former communist countries in central and eastern Europe. Higher degrees of freedom and prosperity are also the rewards to be reaped from the transformation process in the West.

I like the image of people rowing their own boat. The state is no longer a passenger who wants a say in steering. In other words, the European welfare state is in the process of being redefined.

At the end of a long day I have to thank the speakers, the panelists, the participants, the guests, the organisers and all the helping hands. They all together made this European Banking Congress again a success.