

FINANCIAL SERVICES REFORM AND THE STABILITY OF THE EURO

Summary: The exchange rate value of the EURO, though worrying, has to be seen in its wider historical context. Structural reforms, of which the Financial Services Action Plan is a central element, will generate the conditions for a strengthening of the EURO. So will the introduction of EURO notes and coins – the physical expression of the single currency.

The EURO's history to date might be characterised by frustration of initial high hopes for both its strength and stability. Between its launch in January 1999 and its close on 30 June 2000, it has fallen by roughly 20 percent in nominal terms against the US dollar. This has produced a level of criticism aimed at the project of monetary union and, in particular, at the European Central Bank for failing to maintain the strength of the EURO.

Most analysts would agree that at its low point of 87 cents to the dollar, the euro was undervalued relative to the Eurozone's underlying economic fundamentals. By other measures, however, the new currency's track record should not be cause for alarm. First, the euro has traded well within its historic bands, which (using a synthetic euro prior to January 1999) have ranged between 0.70 and 1.50 against the dollar over the past 20 years.

Moreover, the focus on the nominal exchange rate has diverted attention from another important measure of the currency's stability. This is its internal stability as evidenced by the low level of inflation in the eurozone, which has remained below the ECB's target ceiling of two percent. Against this benchmark, the first 18 months of monetary union have been encouraging.

Certain temporary or cyclical factors have contributed to the EURO's early weakness. One is the very strong performance of the US economy, which has made the dollar relatively strong against most other currencies, including the EURO. Another is the fact that EURO notes and coin are not yet in circulation, meaning there is very little real demand for the currency; less than one percent of eurozone payments are currently conducted in EUROS, but this figure will rise to 100% on 1 January 2002. Uncertainty over EU enlargement, meanwhile, has also not helped the EURO's performance to date.

But in the longer term, the value of the EURO will reflect economic fundamentals in the eurozone, and in particular the macro-economic and structural policies that support them. Monetary and fiscal policies will play a key role in this regard. But structural reforms are also critical. Further progress in integrating European financial markets is a key structural reform that is vitally important to the EURO's development.

Monetary union has already brought dramatic change to European financial markets. For example, the corporate bond market in Europe has exploded over the past 18 months as the supply of new government bonds has diminished and as corporate issuers can now tap into investor demand in a single currency area. Technology, meanwhile, is also revolutionising financial markets in Europe and globally.

By contrast, legal and regulatory reforms that are critical to completing financial market integration in Europe have lagged far behind these dramatic market developments.

The European Commission's creation of the Financial Services Action Plan and the political commitment that has been given to fulfilling its aspirations no later than 2005 respond to this. However, after many years of discussion and planning, markets are now looking for tangible actions to deliver on these aims.

The European Parliament has an important role to play in facilitating the fulfilment of the Action Plan. Integration of wholesale markets and the development of open and secure retail services are urgent. A number of legislative initiatives requiring speedy action are coming on to the agenda of Parliament, including a revised Investment Services Directive, proposed directives on collateral, prospectuses and supplementary pensions, and pending proposals on UCITS (collective investment funds).

Rapid action on consolidating the single market for financial services, combined with appropriate fiscal and monetary policies and other structural reforms, will ensure that the EURO becomes the strong, stable currency over the long term that the institutions and citizens of Europe expect.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman of the Advisory Committee.

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