

After the euro: will we need the banks?

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D-Day for the euro is January 1st. This is likely to be an anti-climax for most people, when they realise that they will see no new euro notes and coins for at least three years.

What happens on New Year's Day is that the euro comes into legal existence, and its value is fixed for good in terms of the existing currencies. Consumers and businesses will be able to use it as a unit of account, in running a bank account in the new currency, for example.

People will be able to pay taxes in euros, (and presumably evade taxes in euros, although this is not recommended).

Will it be a damp squib, after all the hype? Perhaps not, at least for medium to large businesses. The coming of the euro may see the final liberation of Irish enterprise from the banking sector, because of its impact on capital markets and financial institutions.

The prospect of a vast, well-functioning, single European private capital market, prompted by the new currency, is being held out. The hope is that banks will no longer be able to carve up their own national markets, especially for financing businesses.

In particular, banks will be less able to act as middlemen between those seeking funds and those willing to lend funds, in that enterprises will be able to go directly to the market.

This aspect of the euro has received little attention, but in many economists' estimation it is one of the key long-term potential benefits of the new Europe.

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Naturally there is much attention to the practicalities of the changeover for businesses: “how do I convert prices? How do I manage payments in at least two currencies? Do I need a new computer system?”

Financial market participants are already gearing up for what has been called the most important change in the global financial system in our lifetime.

When financial markets in the 11 members of the euro area (known as the EU11 , or euroland) open on January 4th all stock and bond prices will be given in euros.

Investment houses and companies which sell market information have been competing to provide the euroland equivalent of the Dow Jones stock market index.

The real changes may take some time. Euroland is moving towards the American model of financing enterprise, one in which bank lending takes a back seat and entrepreneurs go more directly to the market for funds.

Euroland and the US have capital markets roughly the same size, but with very different structures.

The total amount of bank loans as well as company shares and other loans to the government and to the private sector in both euroland and the United States in 1995 was about \$22 trillion (\$22 million million).

In the United States , however, only 22 per cent of these assets were bank loans. In euroland, bank loans accounted for 57 per cent of these assets. European businesses have been much more likely to finance themselves by going to banks for funds, and much less likely to raise money by selling shares or issuing corporate bonds.

In part this has been due to the way in which European banks, with privileged positions in markets divided by language, currencies, and regulation, have had a lock on the supply of capital. The euro will break that lock.

The new currency will transform a set of segmented markets into one vast and deep pool of funds. For investors, borders within euroland (given a single currency) will eventually be as irrelevant as borders between American states.

This is profoundly uncomfortable, particularly for continental European banks. In many cases, they are waking up relatively late to the harsh competitive

forces which will blow many of them away.

The consolidation of European banks which many thought would follow the Single Market in 1992 has been delayed, but it is coming.

The jargon for this process is ‘disintermediation’, reflecting the idea that banks will be pushed aside as the middlemen between market participants who will be able and willing to deal with each other directly.

An irony is that the only European country which would feel at home in a system of dynamic stock and corporate bond markets, Britain, still has cold feet about joining.

Irish banks might fare better than some of their continental counterparts, in that most have tried to address their historically poor relationship with Irish indigenous enterprise. But the catalogue of regulatory failures and sharp practices—to put it mildly—makes them vulnerable.

In one sense, much of the recent debate about who regulates is a debate about the past. In euroland, regulation will fundamentally be about regulating capital markets, at a European level. It will not be about checking whether your local bank manager is doing his sums correctly.

At least for some enterprises, what will matter is whether the stock and bond markets provide a fair and efficient arena in which they can contract with private lenders on the other side of the market, not whether the bank manager is on the other side of the golf course.

The prospects for a well functioning euro capital market are brightened by the fact that governments have been forced, under the Maastricht criteria, to stop borrowing, so crowding out the private sector in its search for funds. Furthermore, most European countries are facing up slowly to the need to provide pensions in the future by financing them in private capital markets.

Of course, the huge uncertainty in the global economy at the moment hinges on doubts about the ability of precisely these types of markets to underpin economic stability and growth.

Europeans may well be wary of committing themselves so strongly to a model which seems under such strain, especially as politicians never told them this.

For Ireland, it may be some time before the venture capital culture overcomes

the historic misperception of banks as something special.

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