3 ACTUALITÉS

1 DISCOURS

1.1 AFTER THE EMU RESCUE – WHICH WAY FOR EUROPE?

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Your Excellencies, Ladies and Gentlemen,

Neither the European Coal and Steel Community Treaty of 1950, nor the 1957 Treaty of Rome dealt extensively with currency. This might have been because convertibility after World War II was not very widespread and capital controls were the norm.

Belgium was one of the first countries to establish free movement of capital but only within a dual exchange rate regime. This particularity had been one of the reasons for Luxembourg to emerge as a financial activities center for Europe.

The principle of fixed exchange rates had been a feature of the international framework for currency stability after World War II for the economies of Europe, North America and Japan. The Bretton Woods System was based on gold and the US dollar as the predominant monetary standard and worked for several years with almost no frictions. By 1968 a new era of currency instability threatened when market turbulence forced the revaluation of the German Mark and the devaluation of the French Franc. These developments clearly revealed the weaknesses of the Bretton Woods System as well as the threats to the common market and specifically the common agricultural policy.

Ideas of a new European currency framework gained momentum and Luxembourg's Prime Minister Werner, also Minister of Finance, was asked to steer a Committee mandated to design the path to an increased economic and monetary integration of the six then members of the European Economic Community. That report, finished on the 8 October 1970 and sent to the Ministers of Finance in the first instance, laid down the achievement of Economic and Monetary Union by 1980.

The youngest member of the Committee and the only one still alive is Hans Tietmeyer. It was he who at the first meeting of the Governing Council of the ECB insisted on the seating arrangements to be changed from countries in alphabetical order to members' family name in alphabetical order. In doing so, he was truly loyal to the spirit of the Werner plan.

In deed, if it took another 20 years after the Werner plan deadline before a single currency was established -, for reasons that would take another conference to explain - it is worth revisiting the Werner report finalized 40 years ago. We can call it truly visionary. Although many of the proposals of the original Werner plan have been realized, some of the original thoughts were ignored or diluted and we might with the benefit of hindsight, ask ourselves whether this has not been a mistake. Of course, the Werner report originated in a different environment when the Union with its original six members still was aiming at a final goal of something like a federal Europe. When, after several run-ups, turbulences and tensions, the goal of a single currency was eventually achieved with the introduction of the Euro in 1999, not only had the number of member states increased, but it had become clear that despite the single currency, there would not be a political union to accompany that currency. National sovereignty in the economic policy-making area would be preserved. Nonetheless, recent turbulences highlight the inherent tensions of European integration, especially those between a monetary policy in which sovereignty is pooled while economic policy remains under national sovereignty. Tensions translate into dynamics either for progress or for regression.

True enough, even during the intergovernmental conference that was to lead to the Maastricht Treaty, there were parallel negotiations for the development of a political union. The political union made only limited progress, while the detailed draft for EMU was hailed as a breakthrough for European integration. In truth, it was once again a compromise between the pooling of sovereign competences at the European level in the monetary area - with opt-in and opt-out clauses for some countries - and the economic union where ultimate responsibilities remained at the national level. Many features were similar to the Werner report like a three-stage approach with a warming-up period (ten years in the Werner plan, eight years in the Maastricht Treaty) or the abolition of all capital controls.

Inside the Werner Committee, the discussions had centered on the sequence of transfer of powers to the European level. Foremost Germany argued that monetary union should follow political union. This so-called crowning theory was inspired by historic developments in other countries. The others on the contrary considered monetary policy union as a powerful catalyst for deeper integration in other policy fields that must follow.

Today, I want to focus on another feature. The Werner report supported the idea of an independent institution for fiscal monitoring and coordination. This thought clearly reflected the concept that a single monetary policy would be supported by sound public finances. More concretely, the report called for ever closer economic policy coordination with an agreed framework for national budgetary policies. At the institutional level, it suggested a "centre of decision for economic policy". This coordination body for economic policies should have been established alongside the European system of central banks, i.e. the monetary authority. Both institutions were to be independent from the national governments, being politically accountable only to a European Parliament. This independent economic authority should have influenced the national budgets with a focus on the level and the direction of the balances as well as the financing of deficits and the use of surpluses, respectively. The Werner report also advocated a certain degree of tax approximation especially for cross-border activities.

When the Intergovernmental Conference on EMU started, Europe had endowed itself with a Parliament, but with limited powers and no capacity to levy taxes and to control centralized policy-making at European level. Most European resources were transfers from national budgets. Tax sovereignty was left untouched after a timid attempt to change tack in the so-called Guigou group set up by President Mitterand to prepare the Conference. During the Conference an attempt by Belgium and Italy to move into the tax area ran into massive resistance.

Political union was off the agenda and loose coordination of economic policies was deemed sufficient. It was believed that market discipline would install responsible behavior in the fiscal and competitive position of countries. The land-grabbing attitude of the European Commission pretending to be the economic and fiscal authority in the event of more integration indirectly strengthened the case for the intergovernmental approach and the so-called own responsibility of each individual country in this respect.

It can seem surprising that governments were so confident about market discipline and reactive national policies when one major factor of self-correction within a currency union was by design rather weak in Europe, namely labour mobility.

True, progress has been made in language knowledge, university students exchange, diploma recognition and access to professions. Mobility is good at the lower and higher skill ends, but the high share of closed public service in Europe, non-portability of pension rights, rigid labour laws and cultural differences make labour mobility a slow process.

Therefore in 1997 the Treaty was complemented by the Stability and Growth Pact which has mostly focused on fiscal deficits. The result proved insufficiently coercive and was even further weakened when Germany and France failed to abide by the rules in 2003. The absence of a meaningful macroeconomic surveillance led to heterogeneity which was further accommodated by the absence of expected market reactions. Today we have to acknowledge that market reactions often come with delays and then tend to overreact.

But let me be clear: Forty years after the Werner report and eleven and a half years after the introduction of the single currency, for me, the verdict is unambiguous: Monetary policy within the Euro area has been a success. It is widely accepted that the best a central bank can do in supporting economic growth is delivering price stability. The ECB has delivered price stability. Even though real GDP in the Euro zone has grown by only 1.5% per year in the first decade since its establishment, while the US economy expanded by 2.2%, this difference can to a large extent be explained by the greater population growth on the other side of the Atlantic. On a per capita basis annual real GDP growth rates are very similar, 1.2% in the US versus 1.0% in the Euro area. The Euro area's economic growth rebounded strongly in the second quarter of 2010, driven by higher investment and replenishment of inventories.

Last week the IMF revised its figures for growth in the Euro area upwards in line with earlier ECB projections. Incoming hard and soft data for the second half of the year do not warrant increased pessimism.

In the course of the crisis of the past three years the ECB and the Eurosystem were forced to act very fast, boldly and innovatively in order to ensure their long-term goal of price stability and the functioning of the transmission mechanism. Their monetary policy interventions were successful. The recovery of the European economy is ongoing and the tensions in the financial systems have eased somewhat, although it is still too early to claim victory.

But we have to draw the lessons from the recent experience. With the eruption of the crisis in September 2008 the accumulation of private debt was suddenly stopped. The problem of excessive indebtedness was not solved, however. Fiscal rescue packages, the impact of automatic stabilizers, and the support of the financial system including guarantees to the banking sector led to a significant increase in public leverage to levels unprecedented in peacetime. In other words, parts of the excessive private debt load were shifted to the public sector.

The crisis exposed institutional weaknesses. Some had their source inside the financial system. Despite some initial temptations for re-segmentation of prudential competences, the response will be at the European and at the EU27 level. It will consist of the implementation of new concepts and institutions aiming at de-risking the financial industry. Liquidity monitoring through a monthly liquidity coverage ratio and a yearly net stable funding ratio will be complemented by macro-prudential surveillance in a European System Risk Board closely associated with the General Council of the European Central Bank. The US equivalent to this Systemic risk Board held its inaugural meeting at the beginning of this month.

Three European Agencies for banking, securities markets and insurance start with a mostly coordination function, but have certain evolutionist competence clauses in their statutes. They have to walk the narrow line between cross border activities of banks and integration of markets on the one hand and competences remaining at national levels like deposit guarantee schemes, resolution procedures, insolvency legislation, i.e. everything that pertains to the tax payer who remains fiercely protected by national governments despite the spill-over effects of cross-border activities, on the other hand.

To tackle these effects through a potential 351 bilateral Treaties in so many areas among 27 member states, can hardly be seen as a stable equilibrium in decision-making nor a level playing field for economic activities in a single area.

The new institutional set-ups at EU level therefore face some of the same problems we experience within the Euro-area. The ultimate goal will however be the same: foster economic welfare through integration of markets and market players.

This obviously will also be beneficial for the optimal functioning of a single monetary policy at Euro area level. The transfer of private debt into public debt as such was similar to what was observed in the whole industrialized world. But the weak institutional framework for fiscal discipline at national and at Euro area level as well as the absence of control by financial markets was emphasized in some countries by three developments:

1. an overextended national financial system
2. an insufficiently strong starting position in the cyclical downturn in terms of deficit and debt
3. a rapidly deteriorating competitive position as shown for example in unit labour costs or current account balances

Suddenly markets reacted and overreacted while Governments excelled in denial and cloak and dagger stories.

This slow reaction forced the ECB into action as a back-stop exposing the unfinished work of the institutional set-up of EMU just as the financial crisis had exposed failures in the macro-prudential area throughout the industrial world.

In both cases, the welfare price of overly relying on market reaction only has become clear. Now credible deleveraging has been implemented in many countries. This action should allow those countries to be back on a sustainable trajectory of growth in the medium term.

A crisis management facility, the EFSF, has been set up as a symbol for the existence of a "community of destiny" that is a monetary union. A common destiny engulfs solidarity. But solidarity presupposes responsibility. This means that crisis prevention mechanisms are even more important than crisis management facilities. And we have to recognize that before a fiscal deterioration occurs and needs corrective actions, we ought to detect early signals in the macroeconomic imbalances of economies that share a single currency.

To overcome the macroeconomic heterogeneity within the Euro area, an explicit and clear framework for the surveillance of competitiveness is needed with the aim of correcting large imbalances. Despite having a single currency and central bank, national economic policies remain insufficiently aligned. Forty years ago (!) the Werner plan was very outspoken on this issue: "Having regard to the marked differences between the member countries in the realization of the objectives of growth and stability, there is a grave danger of disequilibria arising if economic policy cannot be harmonized effectively".

The needed framework is not aimed at increasing the power of the Commission in macroeconomic surveillance in the EU but at highlighting the Euro area dimensions of surveillance and policy adjustments. This dimension requires more automaticity with a focus on countries with vulnerabilities, competitiveness deterioration and high debt levels. It should foresee graduated sanctions at a sufficiently early stage to reinforce compliance. It should take aim at national rigidities that are incompatible with a currency union, like automatic indexation mechanisms of wages and pensions.

On the fiscal side, it is also worth remembering the emphasis that the Werner report put on an independent fiscal authority.

The quality and independence of economic analysis is crucial.

Several suggestions could be made in this respect, for instance increasing the role of the Commissioner in charge of Economic and Financial Affairs akin to the role of the Commissioner in charge of competition. External assessment could also be provided by a Committee of "wise persons". Quality and reliability of statistics need to be reinforced, deadlines in procedures reduced, scope of discretion of exceptional circumstances curtailed and more automaticity introduced. I hope that the Van Rompuy Task Force is bolder on those issues than were the Commission's proposals.

To conclude:

In line with the vision of the Werner Plan, the integration of Europe as an evolutionary process has to continue. The financial crisis of the last three years has uncovered the institutional shortcomings of the current framework and exposed gaps in the existing economic governance regime.

To make sure that the Euro will continue to be a stable and credible currency, monetary policy has to be supported by sound public finances and balanced and sustainable economic growth in the member states of the Euro area. A strengthening of the Stability and Growth Pact, preventing and correcting macroeconomic imbalances at an early stage, and more effective enforcement via gradual sanctions for non-compliant euro-area countries will help to achieve this goal. An independent fiscal authority would help to advance the institutional deepening of the Euro zone and, in this respect, reflect the spirit of Pierre Werner.

1.2 PROSPECTS OF ISLAMIC FINANCE: THE VIEW OF A CENTRAL BANK IN EUROPE

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Islamic Finance Conference
Closing Keynote Address
Frankfurt, Germany
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Ladies and Gentlemen,

It is my pleasure to talk to an audience of such distinguished financial specialists.

Before I embark on what Islamic finance means for central banking in Europe, I will have a look at the growing importance of the phenomenon, its characteristics in the context of financial stability in general and its performance during the financial crisis in particular. Finally, I will present the achievements within my own constituency to overcome the obstacles for an accelerated and safe spreading of Islamic finance in Europe.

Islamic finance: Growing importance

The development of modern Islamic finance roughly started more than four decades ago. At the very beginning it occupied a small niche visible in Islamic countries. In Malaysia the Pilgrim Fund (Tabung Haji) was established in 1969 as an Islamic savings institution.

More recently Islamic finance has expanded out of this niche.

- Worldwide, the assets of Islamic finance institution have grown at double-digit rates for a decade. Even some conventional banks have embarked into the provision of Shari'ah compliant financial assets reaching an estimated 509 billion USD at the end of 2007 according to Moody's[1].

- Today, there are at least 70 countries that have some sort of Islamic financial services. Almost without exception, the major multinational banks offer some kind of these services.

- With the rise of the importance of Sovereign Wealth Funds (SWF), Islamic finance was pushed further. About a decade ago, many emerging countries started to accumulate huge foreign exchange reserves, most of them benefiting from rising oil, gas and other natural resources' prices, being supported by favorable macroeconomic policies. With assets under management of an estimated 3,000 bn USD in 2009, SWF represent twice the wealth of hedged funds. Muslim countries, oil exporters in particular, account for more than 50% of all SWF's assets – not all of which are Islamic finance products, though.

- While Islamic banking remains the main form of Islamic finance, Islamic Insurance companies (Takaful), mutual funds and Islamic bonds (Sukuk) have witnessed strong global growth. The Sukuk markets in particular have gained importance. In recent years, the issuance rose from less than 8 bn USD in 2003 to 50 bn USD by mid-2007[2]. After a sharp decline during the financial crisis, private sector estimates see global sukuk markets rebounding, expecting the total volume to surpass 20 bn USD in 2010[3].

This development might well continue. As Muslim populations are under-banked, and there is an increased financial need for infrastructure projects like roads and housing in many Muslim countries, the demand for Shari'ah compliant financing is still growing. The International Organization of Securities Commissions predicts that as much as half of the savings of the world's estimated 1.2-1.6 bn Muslims will be in Islamic financial institutions by 2015.

The business model indeed could also be attractive outside the traditional Islamic territory, e.g. in Western countries with large Muslim populations, such as the UK, France or Germany[4]. According to estimates, the Muslim population in Europe currently adds up to almost 40 million[5]. Additionally, Islamic finance provides an alternative for ethical investment and can help investors independent of their religious orientation to diversify their portfolios and funding sources.

Ethical foundations of Islamic finance: neither new nor exclusive

The obvious growing importance of Islamic finance calls for a deeper understanding of its underlying principles. The main feature of Islamic finance is the idea of justice.

To a European observer the link between ethics or religion and finance seems awkward at first glance. This connection however is neither new nor exclusive to Islamic countries. It has a long tradition in economic thinking in the occidental world, too.

1 Moody's, Islamic Finance Explores New Horizons in Africa, 2008, http://www.moody's.com

2 Cakir, Selim / Raei, Faezeh: Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk?, IMF Working Paper, WP/07/237, Washington, 2007.

3 Chua, Tony: CIMB Islamic optimistic on sukuk issuance, in: Asian Banking and Finance, August 2010.

4 Imam, Patrick; Kpodar, Kangni: Islamic Banking: How has it diffused?, IMF Working Paper, WP/10/195, Washington, 2010.

5 Lugos, Luis et al.: Finance islamique et droit français, in: Mapping the Global Muslim Population, Pew Forum on Religion & Public Life, 2009.

Remember the reasoning of the German sociologist Max Weber. He argued that capitalism in northern Europe evolved when the Protestant ethic motivated people to engage in business and trade in the secular world, and to this end accumulated wealth for investment. In his view, the Calvinist ethic in particular was an unplanned driver behind capitalism.

Similarly, the founding father of modern economics, Adam Smith, stressed the importance of ethical foundations of markets. Prior to the "Wealth of nations" (1776), he published "The Theory of Moral Sentiments in 1759 – a work, Smith himself considered to be a superior work to his magnum opus.

To sum up: Islamic Banks seek to maximize their profits just like other banks. They have to comply, however, with Shari'ah law – without being religious institutions.

Making the financial system more resilient

For a central bank financial stability is a prerequisite for achieving its goal of a stable currency. The interplay between Islamic finance and financial stability is therefore of particular interest.

Generally, an increasing number of approaches in banking and finance should make the system safer overall because it reduces the concentration of funding sources on the macro level.

On one hand, the particular character of Islamic finance could make banking more resilient to potential financial shocks. The lack of exposure of opaque and complex assets and the absence of excessive leverage should protect Islamic banks from the impact of financial crises. Reliance on deposits rather than wholesale funding adds another layer of stability. On the other hand, the asset-based and risk-sharing nature of Islamic finance can make the business model more vulnerable to second round effects of a financial crisis, i.e. Islamic banks may suffer more from the real economic downturn that normally follows financial turbulences as the losses of the customers are partly shared. Moreover, the lack of product standardization and the missing harmonization of Islamic standards in general pose risks to the management of liquidity.

The judgment on the contribution of Islamic finance to financial stability is therefore ambiguous. In principle, Islamic finance can make the financial system more resilient, although it is more vulnerable towards negative spillover effects from the real economic sector. However, this potential can only be realized, when the regulatory and supervisory regime, the legal framework and payment and settlement systems are robust and current shortcomings in liquidity management are overcome.

Experience during the current crisis

Although we still lack comprehensive and detailed research on the performance of Islamic finance during the financial crisis those pieces of empirical evidence that are available support the former reasoning.

According to a recent IMF study Islamic banks fared indeed better than conventional ones in 2008[6]. This result was however reversed in 2009 when the financial crisis hit the real economy. Overall, Islamic banks performed better within the last three years than their conventional counterparts. Thanks to higher solvency and lower leverage Islamic banks succeeded in matching relatively higher demand for credit at a time when Europe and the US dealt with the threat of a credit crunch.

Moreover, according to various credit rating agencies, the change in Islamic Banks' risk assessment has been better than that of conventional banks (with the exception of banks in the United Arab Emirates (UAE)).

6 Hasan, Maher; Dridi, Jemma: The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study, IMF Working Paper WP/10/201, Washington, 2010.

Ensuring a level playing field

As long as financial stability and the functioning of the transmission mechanism of monetary policy are not at risk, central banks should not interfere with the structure of finance. Ensuring a level playing field can be seen as a prerequisite for functioning financial markets. If the demand for Islamic compliant financial products is rising, obstacles for its further development should be abolished without contradicting the principles of appropriate supervision and regulation nor the prevalent operational framework of central banks. Therefore, the infrastructure and supervisory environment should be provided to allow efficient clearing of a sufficient number of investment-grade Islamic finance papers across the whole maturity spectrum.

While banking authorities are committed to adapt and to be accommodating for Islamic finance within the European regulatory framework, it is crucial to require the same licensing and supervision standards from Islamic financial institutions as expected from conventional banks.[7] Real challenges however remain on the legal side for example asset transferability. But these complications are to a large extent shared with the conventional banking system.

Keeping that balance will be beneficial to both Islamic investors and the European financial system.

Luxembourg's pro active approach

In Luxembourg, private and public decision makers of the financial industry are motivated to establish a regional hub for Islamic finance, making use of Luxembourg's expertise in cross-border finance.

Major steps have been taken already.

- The Central Bank of Luxembourg is a member of the Islamic Financial Services Board (IFSB), a standard setter for financial stability.

- Addressing shortcomings in the Sukuk market such as lack of liquidity and international recognition, small size of issuances, insufficient number of high quality issuers and focus on domestic markets, the IFSB coordinated the establishment of an International Islamic Liquidity Management Corporation (IILM) in October 2010 with the Banque centrale du Luxembourg as a founding member. This new corporation will issue investment grade Sukuk across the whole maturity spectrum in order to facilitate liquidity management for institutions offering Islamic Financial services (IIFS) and cross-border investment flows.

- In 2002, the Luxembourg stock exchange was the first in Europe to receive a Sukuk listing. The number of Sukuk listed today on the Luxembourg stock exchange compares well with the leading stock exchanges in Europe.

- Luxembourg provides the infrastructure for the post trade related aspects of Shari'ah compliant securities transactions, namely in settlement and custody services. In May 2010, the Banque centrale du Luxembourg and Clearstream launched LuxCSD, a new Central Securities Depository for Luxembourg, which will enable the settlement of securities transactions in central bank money and thus be compliant with the highest standards of safety for market participants, providing at the same time a connection to the Euro system project Target2-Securities.

7 Mersch, Yves: Speech at the 5th Economic Forum Belgium-Luxembourg-Arab Countries, in Brussels, 17th November 2009.

- The international expansion of Sukuk presupposes a higher degree of standardization, reliability in terms of Shari'ah compliance as well as robust accounting, legal, tax and regulatory frameworks. The adoption of best practice regulation and supervision requires sufficient differentiation among Sukuk types. Challenges for the expanding market are posed by sector risk due to an overreliance on real estate and construction, the involvement of different laws and jurisdictions together with enforceability issues.

- Luxembourg is the leading location for Shari'ah compliant investment funds in Europe. In 2008 the Grand Duchy set up a task force to identify possible hindrances to the local development of Islamic finance. Tax treatment for common Islamic finance transactions has been adjusted to ensure tax neutrality compared to conventional transactions.

- Skilled staff is essential to any provider of financial services. Dedicated training courses have been set up by the Luxembourg Institute for Training in Banking (IFBL), the Luxembourg School of Finance (LSF) and the university to meet the growing demand for education in Islamic finance.

- Next year in May, the Banque centrale du Luxembourg will host, for the first time in the Euro area, the Islamic Financial Services Board annual summit, a major four-day-conference.

Concluding remarks

Islamic finance provides opportunities and challenges in the context of the agreed goal of enhancing global financial stability.

From the perspective of a European central banker, Islamic finance should be a complement to conventional banking and capital markets, not a substitute. Due to their characteristics, Shari'ah compliant financial products can enhance the stability of the financial system. Shortcomings in standardization and liquidity management must be tackled, however.

Cooperation between investors, issuers and regulatory and supervisory authorities is a pre-requisite for a successful integration beneficial to all stake holders. Luxembourg with its tradition as a specialized financial center will continue its endeavors to establish an international hub for Islamic finance.

2 10-13 MAY 2011 : 8TH ISLAMIC FINANCIAL SERVICES BOARD SUMMIT IN LUXEMBOURG

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