RELATIONSHIP BETWEEN THE 'INS' AND THE 'OUTS'

Remarks by Mr. Urban Bäckström,
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at a seminar in Brussels arranged by the Institute of Economic Affairs on 13th of November 1996

Let me start by thanking you for this invitation, enabling me to elaborate somewhat on the relationship between the 'ins' and the 'outs'. First, however, I would like to say a few words about the situation in Sweden.

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In recent years the imbalances in the Swedish economy have been reduced and the conditions for stability have improved.

- Since the upturn around mid 1993, growth in annual terms has averaged 3 per cent. There are encouraging signs of a renewed recovery after the recent slowdown and the associated stock adjustment process that began towards the end of last year.

- At the same time inflation is among the lowest in the European Union. For the whole of 1996, inflation is estimated at about 1 per cent. The possibility is also good that inflation will be in line with the price stability target of 2 per cent in the next 6 to 8 quarters.

- The general government deficit is diminishing successively, with most of the evidence pointing to a level below 3 per cent in 1997 and balance in 1998.

- The developments in the past year have been accompanied by a reassessment of the Swedish economy, manifested in a strengthening of the exchange rate and a fall in bond rates.

Admittedly, the situation is not bright in every respect. Unemployment is still high. Wage formation has not yet adapted in full to an economy with low inflation. Government debt is still relatively high, slightly less than 80 per cent of GDP, but it is expected to go on falling relative to GDP.

On the whole, substantial improvements have occurred. It is my assessment that Sweden stands a good chance of meeting the convergence criteria for participation in the EMU right from the start.

The discussion is now in full swing on our country's future relationship to the European Monetary Union. The debate is about whether Sweden will belong to the first group of countries that establish the EMU or whether the political process leads us to wait. A decision by the Riksdag, Sweden's parliament, is scheduled for next autumn. In the meantime, the Swedish Central Bank, the Riksbank, is taking an active part in the preparations so that our parliament is in a position to choose either way.

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Europe is now fully engaged in the creation of a single market with freedom of movement for goods, individuals, services and capital. The establishment of the Monetary Union will be an important and natural step in this process. Most of the evidence also suggests that this third stage will begin on 1 January 1999.

The idea of closer economic and monetary cooperation in Europe is by no means new. It was enshrined in the Treaty of Rome, signed in 1957. For various reasons, however, it was not until the second half of the 1980s that the process really got going.

With the establishment of a monetary union, cooperation in Europe will also enter a new phase. It will become more intensive but because - for economic or political reasons - the monetary union will not include every country from day one, the process of integration could be disturbed. The relationship between ‘Ins’ and ‘Outs’ therefore needs to be thoroughly discussed because it involves a number of aspects on different planes. Permit me to consider some of them briefly.

One such aspect is the need to coordinate monetary and exchange rate policy between 'ins' and 'outs'. This issue has featured prominently in the general debate as well as in the work of the EU's institutions. It is also on agenda for this December's meeting of Heads of State and Government in Dublin.

A close policy co-ordination between euro-area and non-euro-area Member States from the very start of Stage Three of EMU is a matter of common interest and forms an integral part of the completion of the EMU process. In order to ensure the efficient functioning and development of the Single Market, it is especially important that real exchange rate misalignments between the euro and non-euro-area currencies can be avoided, as well as nominal exchange rate fluctuations, which would disrupt trade flows between Member States. Under Article 109m of the Treaty there is an obligation to treat exchange rate policy as a matter of common interest.

It is important to bear in mind that the lasting convergence of economic fundamentals, in particular price stability, is a prerequisite for sustained exchange rate stability. Moreover, sound fiscal and structural policies in Member States are equally essential for sustainable price and exchange rate stability. In the absence of a convergence of fundamentals, any attemt to co-ordinate exchange rate policies is bound to be unsuccessful. Exchange rate policy co-operation cannot be a substitute for stability-oriented domestic policies. Let me also add that I believe that monetary and exchange rate policy co-operation should be flexible enough to accommodate different degrees and strategies of economic convergence.

A second aspect, which has not been discussed so much, is the decision-making process. There is, of course, a risk that what was intended to be increased integration in Europe will turn out in practice to contain divisive tendencies between euro-area and non-euro-area Member States.

It is reasonable that countries which naturally belong to the Monetary Union right from the start are so open that even countries joining later are in a position to influence the Union's construction. In this respect there is a high degree of openness, as is evident not least from the work being done under the auspices of the EMI.

In one specific matter, however, there is a tendency that seems disturbing. This is the question of how to treat non-euro countries with respect to the TARGET system - the future European network of national systems for large-value payments. There is a desire among some countries to postpone the decision about this until the ECB has been established and to provide full access to the system only to EMU countries. That would mean that only those countries which participate in EMU from the start will be able to influence this matter and that financial institutions will be hit by negative competitive conditions because some countries do not belong to EMU initially. That clearly must not happen.

This is an example of a disturbing tendency in the relationship between 'ins' and 'outs'. I find it hard to believe that this matter will not be resolved in a forum that includes all the EU's Member States, or that some countries will be excluded from the system. Neither do I expect that the question of TARGET will be followed by more tendencies in the same direction.

What is at stake is potential conflicts between the EU's Member States and their respective financial systems, entirely contrary to the overriding purpose of the European process. If we construct irrelevant barriers and restrictions for the financial sector within Europe, there are reasons to believe that we will not be shifting activity from one European country to another, but could instead be shifting activity away from Europe altogether. Let me, as an example, remind you of what happened in the 1960s when US regulations gave rise to the Europe based Eurodollar market.

This brings me to ***a third aspect,*** namely how to treat non-EU countries. The euro holds the potential for becoming a major world currency, which will then reduce transaction costs for European corporates, due to less FX risk and a more liquid money market. This may increase the potential for invoicing cross-border trade in the (new) home currency. To establish this it is important to help the financial industry in providing an efficient financial environment and a very open attitude towards countries outside the currency area itself.

Let me, as an example, again take a closer look at this aspect with respect to TARGET and the collateral issues. In Stage Three of the EMU all central bank credit, both intraday and overnight, is to be fully collateralised. EU countries are to have a payment system based on the RTGS principle, which means that payment orders entering the system are settled one by one on a continuous basis during the system's operating hours. These systems are very much dependent on liquidity - with a liquidity shortage they can give rise to disturbances in financial activity, since payments can be delayed, or cannot be made in the extreme case.

Sweden was the first country to introduce a fully collateralised RTGS system, in January 1995. This has given us some valuable experience. We have noted that branches of foreign banks sometimes can have difficulties in meeting their intraday liquidity needs. We have, therefore, recently decided to accept foreign denominated securities as collateral for intraday credit, if the central bank of the location of these securities acts as our correspondent or guarantor.

This has been quite controversial for some EU countries which insist on only accepting euro denominated securities issued by EMU entities and located in the EMU area. Even if there will be enough eligible euro paper, our experience shows that there could be circumstances when participants do not have the relevant papers. Consequently, I advocate an open attitude, which I think will favour a sound and stable financial system in Europe. It is also, in my view, important that the future ECB does not force banks to restructure their portpolios in a direction that they might not favour themselves.

The above-mentioned example illustrates the point that potential tensions may arise between a globalisation and regionalisation approach. I am convinced that a regionalisation approach would hamper the evolution of a sound and prosperous financial system in an integrated Europe, and thereby Europe's competitive edge in the global financial system.