

How is the Riksbank affected by EMU?

*Address by Mr. Urban Bäckström,
Governor of Sveriges Riksbank,
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In Sweden a discussion is now in full swing on our country's future relationship to the European Monetary Union (EMU). The question is whether Sweden will belong to the first group of countries that establishes the EMU or whether the political process leads us to wait and see. A decision by the Riksdag, Sweden's parliament, is scheduled for next autumn. In the meanwhile the Riksbank is taking an active part in the preparations that have to be made to put the Riksdag in a position to choose either way.

At the European level the Riksbank is participating in the work of the European Monetary Institute (EMI) in Frankfurt, the forerunner of the new European Central Bank (ECB). We are also represented in the Monetary Committee.

Initiatives for practical preparations in Sweden have been taken by the Riksbank setting up a group for joint consultations in the financial sector. A detailed master plan for the financial sector is to be drafted this winter. We are also drawing up a detailed plan for the Riksbank's internal work.

The timetable is becoming tight but the preparations are still proceeding as planned. Most signs suggest that EMU will be established at the beginning of 1999. As soon as in the spring of 1998 the heads of state or of government of the EU countries are due to decide which countries to include from the start. The ECB is to be established shortly thereafter. When the Third Stage of EMU commences on 1st January 1999, exchange rates will be locked and monetary policy will be taken over by the ECB. Banknotes and coins denominated in euro are to be introduced not later than in January 2002.

The subject of today's seminar is not primarily whether or not Sweden should be a full participant in the EMU. So let us set that aside for a while and assume, for the sake of our

discussion, that Sweden will belong to the first group of EMU participants. What will be the consequences of that?

It is my lot to discuss how EMU will affect the Riksbank. I shall begin by dealing very specifically with the Riksbank's different functions, mainly as regards monetary policy, the payment system and the supply of notes and coins. Then I shall discuss how the EMU process is likely to affect the financial system in a more strategic context and how such changes may concern our work.

The introduction of a single currency in Europe

Monetary policy will be conducted centrally from the ECB in Frankfurt. A single monetary policy is one of a monetary union's basic components. One current issue is the appropriate strategy whereby monetary policy attains its ultimate objective, which is price stability. Will there be an explicit inflation target, like the one the Riksbank is now implementing, or will inflation be tackled indirectly by using monetary aggregates as intermediate targets? The Swedish position is that the difference is not as great as it sometimes appears to be. In both cases the purpose is to safeguard a stable value of money. To this end the central banks analyse a large number of indicators of inflationary pressure, among them various measurements of the money supply. If it turns out that monetary aggregates in the EMU display a reliable relationship with inflation, then this indicator may acquire a special status. Probably the assessment of inflation will have to be based on a wider range of indicators.

There is also a need to harmonise national instruments for monetary policy. Besides repos, other direct market operations by the central banks and standing credit facilities, some countries use reserve requirements. Exactly which instruments will be used is still undecided but there is agreement on a system that has major similarities with Sweden's current arrangements.

The implementation of a single monetary policy throughout the EMU calls for an ability to undertake euro operations promptly across the entire area. This presupposes that the national *payment systems* are linked together, as well as facilities for handling cross-border transactions in securities.

In practice this means that the national systems for large-value payments - in Sweden's case the Riksbank's RIX system - must be harmonised so that they are functionally compatible and supplemented with linking arrangements. All the national systems are to be based - as the Swedish system has been for several years - on the principle of real time gross settlement, or RTGS, which means that payment orders entering the system are settled one by one on a continuous basis during the system's operating hours. This network of national

RTGS systems, which has been named the TARGET system, will make it possible to initiate and settle cross-border euro payments in a matter of seconds.

Clearly, with this European financial freeway, the facilities for making intra-European payments will be very different from the present situation, in which cross-border payments may take several days and often as much as a week.

Now that TARGET's construction has been decided, it is up to the central banks and the banking and clearing institutions to adapt their systems so that these can handle euro and fulfil the other requirements for participation in TARGET. The euro function is necessary so that payments can be sent and received via the RIX system, which will be the Riksbank's entrance to TARGET. The TARGET system is to be supplemented with existing systems for handling securities as loan collateral in the payment system and for the implementation of monetary policy. In many EU countries, settlement systems are wholly or partially owned by the central bank. This, as you know, is not the case in Sweden but the flow of information between the Riksbank and the Securities Register Centre ensures that the preparations are proceeding well.

A specific detail concerns the payment and accounting procedures in the period when the krona is still being used but the euro is being adopted more and more as a unit of value by the central bank, government, business and others. For example, the banks must be prepared to accept incoming payments in kronor while making the equivalent outgoing payments in euro. Somewhere in the system there will have to be a conversion mechanism for translating kronor into euro at the fixed rate. Prior to 2002, of course, the absence of physical notes and coins means that euro payments can only take the form of transactions on account.

The plan is for public authorities gradually to adopt the euro as the unit of value from 1999 onwards. For example, all monetary policy transactions are to be conducted and expressed in euro and new government loans are to be issued in the single currency. One purpose of this is to demonstrate that the new currency has official backing. Private sector agents may change to euro as the unit of value when they find this appropriate (though by the end of 2001 at the latest). The central banks will, however, provide incentives for an early changeover, for example by using euro in their transactions with the banks and in the foreign exchange market. The Riksbank will be making this changeover right from 1st January 1999, from which date the euro will be its unit of account.

The interval between the initial planning for a new *banknote* and the printing and issue of the first series is rather long. Although it is possible that euro banknotes will not be issued before around 2002, work on them has been in progress for some time. A design competition has been launched and a number of firms in Europe have drafted proposals, from which the winning designs are to be selected later this autumn. The competition allows two themes: ages and styles of Europe, in the form of architecture, art or other subjects; and purely abstract designs.

The banknotes will have a wide circulation that will probably include non-EU areas. The opportunity is being taken to incorporate the latest safeguards against counterfeiting. These include watermarks, security threads and other traditional components, as well as more advanced optical features.

The introduction of the euro banknotes and coins is scheduled for the beginning of 2002 and it is envisaged that by the middle of that year at the latest the national currencies will cease to be legal tender. I need hardly add that this process of replacing the national banknotes and coins with the new euro money will entail a great deal of work. In a transitional period, moreover, retailers will have to operate with dual price lists, one in kronor and the other in euro. The timetable for the replacement of existing banknotes and coins is a national responsibility; the Riksbank sees strong reasons for completing this process in appreciably less than six months.

Talk about more *statistical reporting* seldom raises a cheer from the financial sector's representatives, on whom the burden falls. Unfortunately, EMU will involve changes as well as additional reporting. Basically, the statistics on banking are to provide a foundation for the single monetary policy. In order to measure liquidity in the financial sector, the ECB needs information about bank balances and other financial transactions in the member states. There must also be access to other balance-sheet figures of relevance for the general stability of the payment system and the possibility of tensions there. For the statistics to be compiled in the EMU and serve as a basis for monetary policy, they need to be harmonised so that every country reports the same things in accordance with uniform principles. Extensive work on this harmonisation is now in progress.

The preparatory work in the European Monetary Institute covers a large number of fields and in every case there are *legal issues* to solve. One important legal issue is the continuity of contracts. As of 2002, current contracts which stipulate that payments or other transactions are to be completed in the national currency will be performable only in euro because the national currency will have ceased to be legal tender. The Commission has just presented a draft ordinance that could pave the way so that law courts recognise euro payments as a completion of contractual undertakings to pay in a national currency.

Another legal issue with considerably less weight in principle but of great practical importance for us all is the rounding rules for translating national currencies into euro. Conversions are to be made at fixed rates, so it is highly important that the rounding rules are exact and uniform when translating between different currencies involved in a particular transaction.

Payment system stability

Safeguarding the stability and effectiveness of the payment system is one of the Riksbank's major functions. An efficient payment system is essential for the evolution of the market system.

Perhaps what first comes to mind is the system that firms and households use to arrange payments in connection with economic transactions. This includes banknotes and coins, which are directly guaranteed by the Riksbank by virtue of its monopoly, as well as the entire flora of giro facilities, for which the banks have a central function via their exclusive right to accept deposits on account. These components can be said to constitute the payment system's *retail function*. However, as this name suggests, the payment system also includes a wholesale function that is essential for the smooth working of the retail side.

The *wholesale function* includes the RIX system, for which the Riksbank is directly responsible. It is in the RIX system that the daily clearance of the banks' mutual positions is coordinated by the Riksbank. Any surplus or deficit for the banking system as a whole is regulated by depositing in or borrowing from the Riksbank. The Riksbank can be said to be ultimately responsible for the banks being able to perform their functions in the payment system without causing disturbances.

Normally, lending to banks to tide over a liquidity shortage requires sound collateral in the form of government paper, for example. Under special circumstances, however, the Riksbank may grant loans to a bank that has run into serious payment difficulties, though only if the bank can be considered fundamentally solvent and commercially viable in the longer run. The idea behind this is that the Riksbank is to prevent illiquid but basically solvent banks from failing, with the attendant risks of knock-on effects in the payment system. The particular nature of bank balance sheets, with highly liquid deposits and comparatively illiquid loans, means that the stability of the banking system is vulnerable because just the rumour of a suspension of payments may lead to a run on the bank.

These circumstances make it important that the central bank can maintain a state of readiness by being informed about the principal agents in the banking system, which are primarily banks, and their interactions. Besides being in a position to make reasonable financial appraisals of the banks when a crisis looms, the central bank should limit the risk of such crises occurring by continuously overseeing the banks' financial and other operations.

It should be noted here that the Riksbank is not solely responsible for safeguarding the strategic role of the banks in the financial system. In Sweden, as in many¹ other countries, the direct supervision of banks and other financial institutions is assigned to a separate government agency, the *Financial Supervisory Authority*, which has the function of ensuring

¹But by no means all: in the United Kingdom, for instance, the bank supervisors are directly accountable to the Bank of England.

that the specific rules for banking are observed by the institutions to which they apply. As the primary rules tend to be formulated in general terms and explicitly require the Authority to give them a practical guise, the Authority also draws up supplementary ordinances. Finally, the Authority is responsible for keeping the registers and collecting the information that its supervisory work requires. However, the Authority is not in a position to provide banks with liquidity; this, as mentioned, is a function of the Riksbank.

It follows that the Financial Supervisory Authority and the Riksbank have major interests in common, above all in compiling knowledge about the banking sector. To husband resources it is naturally important that this activity is duplicated as little as possible. In practice, however, the Riksbank needs internal competence in the processing and analysis of the banking system's development. It goes without saying that this should include the best possible cooperation with the Authority, not least because the complexity of these problems makes it particularly valuable to appraise matters from more than one angle.

What will the establishment of EMU entail for Sweden's payment system and the Riksbank's role in this respect?

In technical respects, the retail component of the payment system is unlikely to change all that much. To a large extent, Swedish firms and households will rely for their payments on banks and giro systems located in Sweden. The Riksbank will continue to have a central function in the system's wholesale component. The RIX system, however, will be integrated more definitely in EMU's payment system. This process has already begun, as illustrated by the construction of the TARGET system. Another example is the Riksbank's own efforts to broaden the circle of RIX participants by accepting other countries' treasury paper as collateral. The elimination of exchange risk will obviously facilitate this.

Finally, EMU coordination is needed because the conduct of the single monetary policy requires that banks are free to make same-day cross-border liquidity transfers so that interest rate adjustments have a more or less immediate, uniform impact throughout the Union. The RIX system will be one component here.

It is perhaps more interesting to consider how EMU will affect the institutions and markets on which the payment system is constructed and how that may influence the work of the Riksbank in this field.

The “financial revolution”

It is hardly an exaggeration to say that in the past decade the financial system in Sweden, as in most industrialised countries, has been transformed in a revolutionary manner, with consequences that have probably not yet appeared in full.

It should be borne in mind that the financial system is not a new phenomenon, neither has it been developed for its own sake. Its structure has been built up over the centuries as an instrument for aiding production and trade in goods and services. That was true in ancient times when precious metals smoothed the path from barter to commerce. Similarly, the first banknotes proved superior to the earlier tokens of value. While the financial system does go back a long way, in the 19th century its development was stimulated by the advent of the industrial era.

Since the middle of the 1980s, the pace of this development has accelerated again. In the course of a decade financial market turnover has risen very steeply. The same is true of cross-border capital movements. New financial instruments have been introduced. This new phase is presumably in its infancy. Most signs suggest that in the coming century the financial system will become appreciably more extensive than at present.

Deregulation, globalisation, advanced information technology and new methods for valuation and risk management have initiated a dynamic process that involves the interplay of financial markets, institutions and instruments. There are several similarities with the recent centuries of real economic growth, with a continuous stream of new and more efficient production processes accompanied by new forms of communication that led to the expansion of world trade.

The financial developments and their internationalisation are intrinsically natural, a logical consequence of an ongoing increase in global trade, the transformation of production, and worldwide facilities for saving and investment. The new derivative instruments will assist continued efforts to make real economic production more specialised and efficient. In this way, financial developments will contribute to a further increase in prosperity.

The course of development over the years has not always been painless in either the real economy or the financial sector. Historical records contain clear evidence of adjustments of varying harshness and even in our day there have been problems and difficulties. We have experienced bank crises and instances of sudden corrections and wide fluctuations in share prices and interest and exchange rates. The globalisation of the financial sector has created a new and more difficult setting for national as well as international authorities.

The establishment of EMU, with a single currency, will create more stable conditions in Europe. The commitment to low inflation and sound government finance also means that the general economic environment will promote a more stable trend. Even so, the development and improvement of oversight and supervision in the financial sector must continue. International cooperation by various authorities must also be stepped up, particularly now that the risk of problems in one country spreading to other countries is even greater than before. The problems last spring in Mexico are a case in point.

What, then, can the establishment of EMU entail for developments in Sweden's financial sector? As I just mentioned, the answer is basically to be found in a process that has been

going on for more than a decade, in some respects at an accelerating rate. Even without the EMU project, this process would probably have followed much the same lines because it seems to be a natural result of the general drive for European integration. But a single currency for the countries of Europe could clearly have interesting consequences for our financial system and thereby for the Riksbank and the National Supervisory Authority. I should now like to turn to some of these conceivable consequences.

Financial trends

Besides EMU, a number of trends are leaving their mark on the financial system. The adjustments in the wake of the *deregulations* in the 1980s have not been completed. Ongoing advances in *information technology* will continue to have an effect. The *demographic* picture points to an increased need to save for retirement. A *globalisation of enterprise* is being promoted by the EU, NAFTA, GATT, the new emerging economies and the high growth rate in Southeast Asia.

The future path is difficult to predict exactly but most signs point to a continued, rapid development of financial markets, with new instruments and needs for clearance and settlement. Competitive pressure will go on rising in the traditional banking sector, accompanied by a vigorous expansion of long-term demand for financial services, at the same time as investment and the use of capital become increasingly sophisticated.

If this assessment of the future is reasonable, there will be an increased need to restructure the financial sector, accompanied by a need for consolidation in order to withstand the associated strains. The more detailed consequences are difficult to predict but it seems reasonable to suppose that the institutions will become fewer in number but larger in average size. But there will also be a variety of specialised “niche” banks. Moreover, a relative reduction can be expected in the size of traditional bank deposits and advances, accompanied by an increase in the relative importance of the supply of and demand for market-based instruments. This will not be a new departure; the process has already started.

So much for forces that are acting already. On top of them we have the EMU process. Participation in EMU by Sweden would mean that the market for Swedish treasury paper becomes more or less integrated with the larger market for interest-bearing paper issued by the member states in the monetary union. There is little reason to suppose that in time, investors will discriminate all that much between treasury securities issued in Sweden as opposed to, for example, Germany or the Netherlands, at least not if debt ratios (and thereby credit risks) become more uniform because of the necessity of bringing government finance under permanent control. A conceivable result would be a single yield curve for government interest-bearing euro paper in the EMU, or at least a situation where the treasury bonds issued

by different countries become close substitutes. This could imply a radical change in the conditions for the national markets for interest-bearing securities and their derivatives, which today, along with the currency market, are the largest markets in volume terms.

Some argue that in such a situation it is hardly likely that the spot and forward markets for Swedish treasury paper would survive in Sweden; instead, trading in these instruments would be located in a large European market, in some financial centre, where the Swedish paper would be one component of a bigger euro-dominated market. Since, as mentioned, the spot markets for Swedish treasury bills and the so-called benchmark bonds is very sizeable at present and the standardised forwards on these instruments constitute Sweden's largest derivatives market, such a trend would involve a contraction of financial markets in Sweden.

Others argue, however, that there are factors which suggest that the Swedish spot and forward market will continue to exist even after Sweden joins the EMU. The features of a local market may continue to carry weight in that the agents may be expected to devote more resources to the assessment of risks that are specifically national.

These opposed views cannot be reconciled into a clear trend. Of course, a loss of financial markets in Sweden can - and should - be seen as a problem but can also be viewed in a positive context as a starting point for new developments.

Markets for mortgage instruments do exist in Sweden but they are appreciably less active and efficient than their treasury paper counterparts. That is even more the case with corporate bonds (known in Sweden as 'industrial bonds'), where the Swedish market has not been developed at all, except possibly for the shortest maturities.

It is not unreasonable to suppose that a possible loss of national markets for treasury securities and their derivatives would stimulate the development of a market in mortgage instruments, including derivatives, in the EMU. Whether Swedish agents will take the initiative in this process is difficult to foresee and less relevant from the Riksbank's point of view. What does matter is that Swedish banks and mortgage institutions have access to an appreciably broadened market for mortgage instruments and their derivatives, issued all over the monetary union. Besides providing more liquid forward instruments and options for risk management, this implies opportunities for a greater diversification of housing portfolios. It would also lead to a greatly increased demand for the knowledge required for a correct analysis and pricing of various forms of credit risk in the mortgage market.

Moreover, such a development might stimulate the corporate bond market, where the assessment of credit risks and the pricing of risk premia require even more in the way of qualified analysis. The larger the volume of the market, the more it will pay major investment banks to invest in the acquisition of competence in this field.

This technology for valuation and risk management can then be a valuable component of another conceivable trend of particular interest for the banking system. It is the case that in recent years financial enterprises, in Sweden as well as in western Europe, have rapidly

heightened their awareness of and knowledge about risk exposure and risk control. Simplifying somewhat, it can be said that the methods for measuring and managing *market risks*, for example interest rate and exchange risks, are fairly highly developed and known to financial enterprises. The problems may often have to do with management and supervision. It is a question of minimising the risk of abuse and incompetent management à la Barings.

Credit risk, on the other hand, is notoriously difficult to deal with and sophisticated methods for risk management here have not yet come very far in Europe. Judging from recent signs, however, innovations in this field are to be expected. Vigorous efforts are being made at present by American banks to develop methods for measuring, valuing and monitoring credit risks, be these associated with corporate bond issues or with loan portfolios. Mention should also be made of the rapid development of credit derivatives as a means of managing and spreading credit risks.

These developments have given rise to what are known as loan sales, a procedure whereby a bank sells a proportion of its loan stocks to another bank or banks and possibly replenishes its balance sheet with equivalent purchases of loans granted by other banks. At least a part of each of the loans that make up such a loan sale is of course retained by the bank that originally granted it, thereby underscoring that the bank is not selling off bad loans and still has an incentive to go on monitoring and even influence the borrower's financial position. The consequences resemble those arising from a broader market for corporate bonds. Conditions are created for a more efficient valuation of credit risks and therefore for increased diversification and risk spreading.

Even if such a tendency in the management of credit risks might ultimately show up in any event, it may be stimulated by the establishment of the monetary union, which eliminates all exchange risks between the participating countries.

Another trend is for the mediation of payments to generate increased bank earnings, for example via the introduction of smart cards. Considering the demographic tendencies in Europe that I mentioned earlier, it seems that capital management should also be a growing field.

My analysis has concentrated in the main on instruments and risks. At a deeper level there are also institutional aspects, by which I refer to how the EMU process affects banks of different types, for instance small as opposed to large banks and banks in small or large countries. It may also be asked whether non-bank financial institutions will gain or lose market share. Then there is the issue of institutional hybridisation. But time does not permit a closer look. And by now my point should be clear, namely that the establishment of EMU can have fairly far-reaching consequences for financial markets and institutions in Sweden and the rest of Europe. The changes will occur in conjunction with the other forces that are already at work. This type of transformation and development of the financial system will

require a great deal of overseers and supervisors. The tasks will be addressed ambitiously by the Riksbank in the years ahead.

Concluding remarks

Even if monetary policy is to be decided in Frankfurt, those of us who work in Sweden's central bank will not be short of tasks. Here are some examples. The governor of the Riksbank will need an entity for analysis to support the line he or she will be advocating in Frankfurt. It is conceivable, moreover, that national central banks in Europe will specialise in different fields of analysis, along the lines practised by District Federal Reserve Banks in the United States. Another matter that is being discussed at present is whether the pool of foreign reserve assets is to be managed centrally in Frankfurt or be decentralised to the respective national central banks. There are also many indications that, at least initially, the monetary policy operations will be actually executed in a decentralised manner by each central bank in the participating countries. This means that the Riksbank will still be responsible for the national payment system. To this can be added the responsibility for the distribution of banknotes and coins. Ensuring a supply of physical means of payment throughout Sweden is currently a very large component of our operations. That will continue to be the case even if the notes and coins are denominated in the euro instead of the krona. In addition to the above, there is the function of closely following future developments in the financial system in order to promote a reliable and efficient payment system.

All this means that much will continue to be required of the Riksbank's work, at the same time as we, just like many others, will carry out changes and adapt our resources and functions to the new requirements inherent in the establishment of the European Monetary Union.