

EMU, monetary policy and the financial markets

*Address by Mr. Lars Heikensten,
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I should like to begin with a word of thanks for the invitation to speak to you here about how EMU may affect monetary policy as well as the financial markets.

EMU's implications for Sweden in general and for the financial markets in particular have recently attracted growing interest, which is hardly surprising. We are rapidly approaching the date on which Stage Three is intended to begin. The political will in Europe has concurrently become increasingly clear. As a result, the view is spreading - not least in financial markets - that EMU will begin on time and that a large proportion of EU's member states will participate from the start.

It is my impression that in Sweden we are lagging behind. One unavoidable reason for this is that the decision whether or not to join the euro area is not due until next autumn. But regardless of whether we will be participating from the start, from a later date or not at all, EMU will affect us in numerous ways that need to be analysed and prepared for.

Today I shall be concentrating on three topics: monetary policy with EMU, how EMU is likely to affect the financial sector (its institutions as well as its markets) and the role of the Riksbank if we join the euro area. As my time is short, I shall be suggesting issues for further discussion rather than providing final answers, which perhaps do not yet exist.

The strong call for EMU information has prompted the Riksbank to arrange a number of addresses recently on much the same topics as today's. Those of you who want a more detailed picture of how we appraise the consequences for the financial markets can read what Urban Bäckström and Stefan Ingves had to say in their talks last Thursday, October 17th.

1. Monetary policy

When EMU is established, monetary policy will be decided in Frankfurt. The single monetary policy is the linchpin of the monetary union.

For Sweden it will naturally be highly important whether we participate or not. Membership from the start would mean that we can influence not just the construction of policy but also how the ECB chooses to work, how policy is put together and so on.

Several issues of relevance for future policy are being discussed today within the framework of the EMI. Formally, however, the conduct of policy is to be decided exclusively by the participants in the euro area. There is already a tendency for countries that are perceived as belonging to the potential core to have a greater influence over the process.

Current issues

Now for some brief remarks about the topical monetary policy issues. Many of them also have consequences for the financial markets.

1. Institutional matters. The Governing Council of the ECB will be made up of the ECB's executive board and the central bank

governors of countries that are participating in EMU. The implementation of monetary policy is a matter for the ECB's executive board, which is appointed for a term of eight years by the heads of state or of government in the EU. All the national central banks (NCBs) will be included in the European System of Central Banks (ESCB) and they will be required to have an independent status, whether or not their country is participating in the euro area.

For Sweden, one consequence of the Maastricht Treaty is that the status of the Riksbank's governor will have to be clarified; removal from office is to be allowed only if there are specific grounds for this, such as serious misconduct, etc. The composition of the Riksbank's governing board could be another problem. The practice of including members of parliament is entirely contrary to Central European traditions.

2. *Strategy.* As indicated in the media, a discussion is in progress on the ECB's strategy for attaining the ultimate objective of price stability. Should there be an explicit inflation target, of the type adopted by the Riksbank, or should the ECB tackle inflation indirectly by conducting monetary policy with reference to an intermediate target, for example the growth of the money supply?

Sweden advocates an inflation target, which in our view has worked well. It is educational in that policy has its sights on the ultimate objective. It also assists an open and constructive assessment of central bank performance, which we see as an advantage when building up confidence in a new European institution.

This issue is still being discussed. Whatever the solution, the ECB's strategy will have price stability as the primary objective. One should therefore not exaggerate the difference between an inflation target and monetary targeting. Experience has shown that *in practice* most central banks in the EU operate with numerous indicators in a manner that is not all that different from ours.

3. *Instruments.* The instruments of monetary policy will also be harmonised. There is agreement that the ECB will provide a marginal lending facility and a deposit facility, and that repos and other open market operations are to be used in much the same way as our present procedure.

The debatable items include the need for credit facilities with a maturity of more than one week and the need for reserve requirements. Our position has been that the system should be market oriented, without reserve requirements, for example. To date it has been decided that preparations are to be made for the use of reserve requirements. The decision whether or not to introduce reserve requirements rests ultimately with the ECB.

A much-debated issue is which securities are to be eligible collateral for payment system loans and for monetary policy transactions. Some central banks that only recommend securities denominated in euro and issued by parties in the euro area should qualify. We consider that the system would work better if the decisive matter were to be, not the issuer's country of establishment but the security's credit risk.

4. Monetary policy's execution. In large measure the operational use of the monetary policy instruments will be decentralised to the NCBs. In Sweden, as in some other countries, in recent years we have been operating with a small group of monetary policy counterparties - primary dealers. A majority of the EU area's central banks, including the Bundesbank, have engaged considerably larger groups. What the ECB will do in this respect has not been decided but there are many signs that the counterparties for monetary policy transactions will be drawn from a wider circle than is now the case in Sweden.

5. Management of the ECB's foreign reserves. A further issue relating to monetary policy is the composition and size of the joint foreign reserves. The aggregate foreign reserves of the participating countries clearly exceed the ECB's requirements. The euro will most probably have a flexible exchange rate with the other major currencies, so the need to defend a particular rate will be small. It does seem likely that the ECB will be required to intervene at the limits of the margins with other EU countries within the framework of a future ERM 2; but as the euro is intended to be the anchor currency, such interventions will primarily entail purchasing weaker currencies.

The central banks of countries participating in the euro area are to transfer a proportion of their reserves to the ECB. There is reason

to suppose that the ECB will decide that the management of these reserves is to be decentralised, at least initially. The foreign reserves will be rearranged in favour of non-European currencies; during the transitional phase this may have effects on currency markets. The available studies suggest, however, that "portfolio effects" of the rearrangement are limited.

Ins and outs

While I am on the subject of monetary policy, something should be said about what might happen if Sweden were to end up outside the euro area. This would not have much effect on some of the issues I have mentioned, for instance the institutional aspects. For example, Sweden has already undertaken to amend the law to strengthen the independent status of the Riksbank's governor. Matters are otherwise as regards strategy, instruments, reserve management, etc. But while there would be effects here, the construction of our system would ultimately be our concern.

Monetary policy could be conducted with an inflation target as well as with a fixed exchange rate with the euro. If Sweden has not joined the ERM, we would be under strong pressure to join its successor; there is also a risk that a period of ERM participation will turn out to be a requirement for EMU membership. In any event, we have undertaken to regard exchange rate policy as "a matter of common interest", which clearly limits the degree of freedom in monetary policy.

It is sometimes claimed that even if we remain outside EMU, monetary policy will be deprived of its significance. The ECB, it is argued, will decide everything, just like the Bundesbank at present. That, however, is an exaggeration. An outsider would have room to manoeuvre and economic shocks, for example an increase in inflation, could be parried with measures of monetary policy. But the fact remains that as an insider, Sweden might find it easier to avoid some of our earlier mistakes and it is just such mistakes that might have to be corrected with the aid of monetary policy.

Fiscal policy will also be constrained whether or not we join EMU. As an outsider we would have to work to fulfil the Maastricht requirements and our policy would be monitored

continuously in this and other respects. The Commission proposes, for example, that the convergence programmes are to be mandatory and serve as a foundation for a continuous monitoring of policy. For participants, the Maastricht requirements are replaced by the stability pact, which has come a long way since the German finance minister presented proposals almost a year ago. But its basic idea is still to commit the EMU participants to the continued consolidation of government finance once EMU has begun and to penalise those that fail to keep the public purse in order.

This idea has Sweden's support. Problems could arise, not least for small countries, if a major player in EMU were to neglect its duties and thereby jeopardise the Union's budget policy and the level of interest rates. The difficulty has been to find models that "penalise" miscreants without reducing the flexibility that may be needed to accommodate national differences of opinion about the size and structure of the public sector, etc. There must also be a possibility of using fiscal policy to deal with shocks that occur in a part of the Union in connection with sizeable cyclical differences or structural changes.

The relationship between EMU participants and non-participants - ins and outs in EU jargon - contains many questions. Good progress has been made both on monetary and exchange rate policy and on fiscal policy and the stability pact. As the discussion proceeds, however, new issues come up. In a situation where the ins "pool" their central banks and adopt a single monetary policy, should not their fiscal policies also become more coordinated? And would this not soon lead to the existence in the EU of an inner and an outer circle in the field of economic policy? It is difficult to know for certain how close the resultant coordination of fiscal policy between ins and outs will be; but in any event outs may risk losing influence by not joining the club.

2. The financial sector

The effects of EMU on the financial sector will be considerable. Probably the most important are the general consequences of national economies becoming more integrated, the reinforcement of the single market and the single currency's enhancement of

competition and specialisation. To these should be added effects of institutional and legal arrangements of the type I mentioned earlier in connection with monetary policy; they will no doubt emerge in other areas as well (government borrowing, supervision, etc.).

Continuation of existing tendencies

The general effects refer to circumstances where EMU as such is of limited importance. To a large extent they amount to a continuation of existing tendencies. Examples of factors that are likely to go on contributing are deregulation, information technology, new financial theory, the institutionalisation of saving, the ongoing corporate internationalisation, etc.

It is, of course, impossible to predict just how the tendencies will develop. Their course to date points to a further rapid evolution of financial markets, with new instruments, more hybrid institutions, the concentration of certain specialist functions, new forms of clearing, etc. Competition in traditional banking will no doubt continue to tighten, accompanied by a rising trend in demand for financial services as well as increasingly sophisticated clients in both the corporate and the household sector. It seems likely that full-service banks will become fewer but larger, along with a growing number of niche banks or financial companies offering just a few services or distributive channels. We can probably also expect a continued contraction of traditional bank lending and depositing, with a rising demand for market-based instruments. Just how much EMU will mean for these tendencies is, however, debatable; they have more to do with integration at the global level and in the EU's inner market.

Capital market specialisation

Today's capital markets in Europe are fragmented. Domestic banks and insurance companies have a dominant position in most countries and Sweden is no exception. The effect of national currencies in this context is presumably less than customers'

preference for banks they know and the banks' fund of knowledge about credit risks and local markets (the church tower principle).

Except for the changeover to a single currency, the arguments in favour of a national base will still apply in Stage Three. Together with linguistic difficulties, they suggest that the *retail function* will be influenced mainly by factors other than EMU. In time, however, the participating countries are likely to become increasingly integrated. As uncertainty diminishes, various economies of scale (in the development of computer systems, etc.) may then play a greater part in structural changes.

In the case of *specialist functions* such as corporate finance, rapid internationalisation is already in progress. It is likely to continue and a key question here could be where, in which centres, the operations will be located. EMU may turn out to be more important for the expanding field of fund management. The elimination of exchange risks will make it more natural to buy into foreign funds. Similarly, changes may be made in the regulations for pension foundations, etc. Both cases would result in more financial integration and stronger competition. Perhaps there would also be a further accentuation of analytical work, with more specialisation as one possibility; Swedish banks know a great deal about forest industries, for instance, Norwegian banks about petroleum, etc.

Increased importance of credit risk

As regards markets for interest-bearing instruments, one of the first things to consider is how a new *risk-free interest rate* for the euro might be established. Unlike the case in the United States, for example, there will no foundation in the form of a single, easily identified treasury rate. Instead, it will be up to market agents to decide which rate to regard as free of risk. Country credit assessments will be a central factor here.

With no exchange risk, differences in the valuation of different instruments will refer to credit and liquidity risks. In time, however, *credit risks for treasury paper* may also converge. This is suggested, particularly for short maturities, by the stability pact's emphasis on sound government finance. But there are other factors

which suggest the opposite. Today's exchange risks incorporate assessments of each country's ability to manage its economy as well as its government finance. With a single currency, part of this will be included instead in assessments of credit risk. Moreover, problems with government finance can no longer be tackled by easing the monetary stance. All this suggests that country differences in treasury interest rates are entirely possible. Another conclusion is that banks and other financial institutions may wish to diversify their portfolios in terms of country risk. Such a development might add to Europe's financial integration.

While differences exist between EMU and the United States in the matter of treasury paper, in other respects the parallel may be more instructive. A European market for *corporate bonds* is a probable development, for example. These markets are small at present and in most countries not particularly liquid. Perhaps they can become more lively when trading is based on credit risk rather than exchange risk. Looking further ahead, there could be a stronger link between trade in interest-bearing corporate instruments and equity. Perhaps investors will also diversify risks, etc. in relation to different industries rather than to national borders. In that case, credit assessments and industry-related knowledge could become important competitive tools.

Another probable effect of an euro market without exchange risk will be a consolidation of the rapidly growing *derivatives markets*. National experience to date points to a need for just a few different contracts in each currency, enabling investors to play the yield curve. Judging from what has happened in the United States, moreover, it does not pay to break into this market once a party has become established there. The first to achieve liquidity would seem to be the winner.

Location effects not self-evident

Before moving on from EMU's effects on the financial sector, there is also reason briefly to mention conceivable consequences for the location of financial activities. Historically, it is not the case that trading has been attracted automatically to cities that house a central bank. Cases in point are New York, Milan and, as it happens,

Frankfurt. From this perspective it is therefore not self-evident that, just because EMU is established and Frankfurt has been chosen as the site of the EMI, Frankfurt stands to gain much at the expense of, for example, London.

The primary considerations in the location of financial activities are the setting in general, rule systems, access to specialists, etc.

A potential threat to London - and, for that matter, Stockholm if Sweden were to remain outside EMU - lies in protectionist measures. One example of this in our view is the idea that access to TARGET, the European payment system, should be restricted for countries outside the euro area. At the same time, TARGET illustrates the difficulties in achieving such discrimination; there are ways of circumventing the rules, though that would not confer the increased reliability of the payment system that TARGET represents. There is often a risk of the rule-setters being hurt by their own devices - of the market moving to a location where it can develop in a reasonably free and rational manner. A good example of this is actually the emergence in the 1970s of a Euro bond market outside the country of issue.

There are numerous arguments against all financial operations being concentrated to one or a few centres:

- Monetary policy will probably be executed at the national level, implying a continued need of primary dealers as counterparties and sources of information.
- A majority of the investors in the bonds issued in a particular country are to be found today in that country; while increased diversification seems likely, it will take time.
- Local knowledge may prove particularly valuable for the assessment of less liquid paper with a sizeable credit risk (anything from mortgage paper to corporate bonds and equity).
- The banks will continue to rely on local ties for credit assessments and customer relationships.
- Technical advances may also favour decentralisation. There are growing facilities for working at a distance with remote access. This tendency is being facilitated, moreover, in that electronic trading is reducing the importance of the trading floor. It could lead to the emergence of an electronically linked network of exchanges and clearing institutions. The Stockholm Stock Exchange has high

ambitions in this respect which I assume you will be hearing about from Bengt Rydén.

Briefly, then, there are many indications that, with its favourable setting, London will be able to maintain its dominant position in Europe even if the United Kingdom does not participate in EMU. For a country such as Sweden, EMU affords good opportunities. The financial sector is capable of developing provided it has a good environment.

3. Role of the Riksbank

Finally, a few words about the role of the Riksbank if Sweden does participate in the euro area.

A change of emphasis

The *monetary policy* decisions will be made in Frankfurt but they will require a foundation and the policy has to be executed. Concerning the foundation, I see strong arguments for continued activity in Sweden. There is good reason to nurture our analytic tradition, not on nationalist grounds but because it has something to contribute to the work being done in other EU countries. An inspiring example is the division of labour in the United States between various District Federal Reserve Banks. An international coordination of statistics in the field of the Riksbank is in progress but production and processing will continue to be essentially a national activity.

Aspects of the implementation of monetary policy can be decentralised. The national central banks have a valuable fund of experience. Centralisation, moreover, may be difficult to manage if there are numerous counterparties. We consider that, in general, implementation should be national to the extent that this is rational; but in this area, just as in the management of foreign reserves, for example, there may be arguments from effectiveness that point in the opposite direction.

Similar arguments apply in other respects, too, for example the *payment system*. A distinction should be made here between the

wholesale function, via electronic systems such as RIX, etc., and the retail function. In the former case the main line is to link the national systems into a network. As regards the distribution and other handling (quality checks, etc.) of banknotes and coins, the openings for centralisation are naturally limited. In time, however, new technology (smart cards, etc.) may have a major impact here.

Finally there is the role of the Riksbank as the overseer of the reliability and workings of the *financial system*. This function is changing rapidly but its fundamental purpose will certainly be at least as important after the establishment of EMU as before. The ongoing specialisation and financial integration will raise new problems and issues. At the same time, economic development in the euro area could be relatively stable, at least compared with our experiences in Sweden over the past decade. This should ease the overseer's task. An important aspect of the Riksbank's function here is how we can contribute to a good environment for financial activities and thereby add to Sweden's attraction.

A Swedish profile

Permit me to end by underscoring what we perceive as Sweden's profile in European cooperation, a profile that is not ours alone but one that we are concerned to promote.

- It involves *transparency* and the possibility for people in this country to acquire an insight. We strive to be as understandable as possible and thereby to further an understanding of what we are doing. This leaves its mark on our arguments concerning the ECB's monetary policy strategy and it guides our discussions of what should or should not be published.

- It also involves a belief in *market oriented solutions*. This applies in the approach to monetary policy's implementation (instrumental systems, etc.) but also to how we consider the markets should function, rule systems be constructed and so on. We see this as the best way of promoting financial markets that contribute to prosperity and also consider it to be Europe's opportunity of being competitive with the rest of the world in the financial domain.

- Finally we safeguard *free trade* as far as possible. Here, too, there are specific examples. One is our position that many

categories of security should be eligible as collateral for monetary policy transactions. Another is our opposition to restricting access to the payment system that is being built up for transactions between central banks.

If Sweden does not participate in the euro area, our opportunities for asserting these positions on European developments will be limited.