

Speech

Deputy Governor Stefan Ingves

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The consequences for Sweden if we join the euro area

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I should like to begin with a thank you for the invitation to speak here about EMU and effects it may have for Sweden's financial markets. More and more people are becoming interested and engaged in these matters, which is only natural as we approach Stage Three's stipulated starting date and the whole thing seems increasingly likely to happen. The recent meeting of finance ministers and central bank governors provided further confirmation of this.

Today I shall be recapitulating the timetable for EMU's third stage, the changes we already know will occur and the Riksbank's practical preparations for EMU. I will also be discussing what the consequences for Sweden's financial sector are likely to be if we do join the euro area as well as if we do not.

At present no one knows exactly how large or swift the effects will be of introducing a single European currency. EMU is a truly unique project; there is nothing with which to compare it and no experience to draw on, at least in modern times. So I think we should be rather humble about predicting effects and assessing drawbacks and advantages. Moreover, while this is a matter of economics, it involves much more than economics. Even so, one can form a fairly sound opinion about the direction and approximate strength of various effects and in my opinion this makes it possible to take up a position.

Why EMU and why should Sweden join?

Monetary union or not?

That the monetary union will be established according to plan is highly probable - the political will is strong, as manifested time and again when the process has seemingly been threatened by differences of opinion and doubts. This makes it less relevant to discuss whether or not the project is a good thing in principle or in general. What we now face in practice is the question whether we want to board the train that will probably be leaving the platform on 1st January 1999, whether we should wait for the next departure or whether we should go home.

Sweden should join from the start

The basic idea behind EMU is simple. A single currency confers gains in efficiency, which implies increased resources and greater prosperity. The elimination of exchange costs lowers transaction costs. The absence of exchange rate fluctuations simplifies trade and investment. Price comparisons and economic estimates become more straightforward, not least for individuals and small firms. Price transparency throughout the euro area will promote competition and tend to keep prices down, to the benefit of consumers.

As regards the Riksbank, our governing board has concluded that Sweden should join the euro area and do so from the start in 1999. We consider that the economic and political gains of joining have been underestimated, for instance in the Calmfors report, while the costs for stabilisation policy have been exaggerated.

To elaborate, one of the most frequent arguments against joining is that we must be able to devalue in order to cope with asymmetric shocks (economic disturbances that exclusively hit Sweden); such shocks are very liable to result in increased unemployment and to prevent this we need to be able to adjust the exchange rate. This line of reasoning is often referred to as the insurance argument. This insurance is not available in a monetary union with locked exchange rates; as a member of the euro area, Sweden cannot respond to economic problems by devaluing the currency.

In this respect our view of economic policy differs from that of opponents of the union. Monetary and exchange rate policy cannot resolve problems that in practice have often arisen not so much from asymmetric shocks as from the conduct of economic policy and from persistent, self-inflicted structural problems. The problems highlighted in the EMU report, such as the risk of increased unemployment, are naturally a matter of the utmost concern. But the solution to the problem of unemployment lies, not in monetary and exchange rate policy but primarily in changing how the labour market functions.

The political consequences

A discussion of EMU's economic effects is clearly important. Another important matter is the political consequences of joining or remaining outside. Here we agree with the EMU report - staying outside has political costs. It will exclude us from the inner circle of countries that will be steering Europe into the future. Our decreased possibility of influencing decisions will presumably apply in other areas besides monetary policy. If Sweden were to refrain from joining the euro area at all, there would be a risk of being marginalised as an outsider. It should also be realised that countries belonging to the euro area from the start will exercise more influence on the development of the European Central Bank (ECB) in its formative early years.

We should ask what kind of Europe do *we* want to construct and how can *we* participate in and contribute to this. Of course we are free to stand by and watch the other countries making progress in this cooperation - but we should be aware that in doing so we are making a choice.

I have difficulty in envisaging that Sweden would want to stay outside a functioning euro area for a long time. The countries and economies of Europe will become enmeshed. So the question, as the EMU report also concludes, is not *whether* but *when* Sweden ought to join. Put that way, the matter becomes less dramatic.

Permit me now to look at some of this project's more practical aspects.

What will happen?

Sweden and the convergence criteria

Taking the convergence criteria first, it can be noted that they do not entail a new line in Sweden's economic policy. Three of the criteria concern the Riksbank directly, namely those for price stability, the long bond rate and exchange rate stability. At present the rate of inflation in Sweden is one of the lowest in Europe and we expect that Sweden will continue to fulfil this criterion in 1997. We probably also fulfil the interest rate criterion. The exchange rate criterion has occasioned much discussion; some consider that to qualify, a country must have participated in the exchange rate mechanism (ERM) for at least two years prior to the examination, while others argue that what matters is the currency's stability in practice. Sweden sides with the latter view. As regards the remaining criteria, the budget deficit for 1997 is forecast to be in the vicinity of 3 per cent and the Government has declared a readiness to take measures if the deficit develops unfavourably. The government debt ratio, on the other hand, is currently around 80 per cent of GDP and can hardly be reduced to the stipulated 60 per cent by 1997. On this point, however, the Maastricht Treaty allows a flexible interpretation; a ratio above 60 per cent is acceptable if, for instance, it is diminishing sufficiently and at a satisfactory pace.

All in all it therefore looks as though Sweden will in fact fulfil the convergence criteria. Naturally this makes it still more relevant to initiate preparations even for those who were hesitant earlier. What, then, lies ahead?

A brief timetable

In almost exactly one year's time, during a weekend in late April or early May 1998, the European Council will confirm which countries will be adopting the single currency. The assessment is to be made in the light of which countries fulfil the convergence criteria on the basis of statistics for 1997. On 1st January 1999 exchange rates are to be locked and the conduct of monetary policy will be transferred to the ECB. Moreover, the euro is to be introduced and used for all monetary policy transactions. Until 1st January 2002 at the least, euro and kronor will exist side by side but legally they will be *one and the same* currency. That is no odder than the fact that Sweden's krona can also be expressed in öre. During this interval, however, euro will not be available for our wallets. The physical introduction of euro banknotes and coins is scheduled for not later than 1st January 2002. When that happens there will be six months for a massive exchange of the national notes and coins. By 1st July 2002 at the latest the krona will cease to be legal tender but the Riksbank will of course continue to exchange kronor for euro.

The preparations in Sweden

It is the Riksdag (Sweden's parliament) that decides about Sweden adopting the single currency and it is up to the Riksbank to ensure that Sweden is actually in a position to join if a majority of the Riksdag so decides. That is why preparations are already necessary.

The Finance Ministry and the Riksbank each have arrangements for the euro's practical introduction. A basic principle is that the work shall be voluntary - the adaptations to be made are a matter for the individual organisation to decide. All those concerned will also have to solve any problems they encounter as a consequence of EMU.

One result of our work to date is a situation report on the euro in Sweden's financial sector, published at the beginning of February. The report was prepared together with representatives of the financial sector and accordingly contains our views on the changeover issues as well as appended statements from a dozen other organisations. This is the first report to give an overview and a compilation of EMU preparations in Sweden's financial system.

In the report we conclude that the preparations in the financial sector have made good progress. Timetables and appropriate solutions have been put forward in a number of fields. The Riksbank therefore considers that the financial sector can cope with a changeover to the euro on 1st January 1999. We also see that joining later would make the preparations more difficult in some respects and easier in others. The worst alternative would be a long period of uncertainty about our participation, what we usually call a "soft no". Costly double systems would then be required in several areas. We have also observed concern in the financial sector that staying outside the euro area would entail increased costs, competitive disadvantages and risk various forms of discrimination. This is pointed out in the report as well as in the Riksbank's submission on the EMU report. Our work on the preparations will be continuing this spring.

What will change?

How will EMU make itself felt? What are the most significant changes for the financial system? What will people in general notice? Here is a brief account of some of the changes we know will happen in a number of important areas.

1. *Monetary and exchange rate policy*

A single currency implies a single monetary policy, which in EMU will be decided by the ECB. The Riksbank and the other national central banks will have the task of executing this policy. The changes for Swedish banks and other financial institutions will probably not be all that great. The Riksbank is likely to remain the financial sector's counterparty. The main differences from today for Swedish banks are a much larger market for intra-day money and counterparties located all over Europe.

The detailed conduct of monetary policy is not yet clear. The final decisions are due when the ECB has been established in 1998. Consequently it is the countries participating from the start that will be able to influence the conduct of policy and the organisation of activities in the new European central bank. Today there are already tendencies for those that belong to the perceived core of member states to exercise a greater influence on the process.

2. *Payment system*

The conduct of a single monetary policy calls for a single system with which to handle the associated payments. TARGET, the payment system that is now being built up, will link up all the national systems - in Sweden the RIX system - to form a common network.

A payment from a bank in, say, Stockholm to another bank in Copenhagen or Milan will normally be executed in a matter of seconds, whereas at present it takes at least a day. TARGET's main purpose is to enable the ECB to conduct monetary policy but it also amounts to the establishment of a new expressway for commercial transactions. The extent to which banks and other companies use the system will probably depend on the price. What this will be is still being discussed but the principle is to be full cost recovery and a pricing policy in line with EU competition law.

All the national central banks in the EU area will be entitled to join TARGET, whether or not they have adopted the single currency. Discussions about the construction of the system point, however, to a significant risk that countries outside the euro area will have more limited possibilities of using TARGET, for instance due to restrictions on intra-day euro credit, which is important for countering fluctuations in payment flows. One of the matters discussed is that outsider banks should close the system at an earlier hour. The Riksbank has acted forcefully to oppose this threat of discrimination. The decisions on this and certain other matters have been deferred, however, and will now be taken by those countries that join the euro area from the start.

TARGET is to be tested this summer and is to be fully operational by 1st January 1999.

3. *Laws*

Everyone must be able to count on the euro having a sound legal status. Economic values, for example in contracts, bank accounts and pension agreements, must be guaranteed in the interval between 1999 and 2002, when the euro and national currencies are coexistent.

Firms and individuals need to be certain that contracts concluded in kronor still apply when the euro has been adopted - the principle of contractual continuity. This and much else is regulated in the euro ordinances, which will be directly applicable in all countries that adopt the euro and thus in Sweden if we join. We will probably also have to amend our national laws.

One national legal issue is the status of the Riksbank. The Maastricht Treaty calls for a greater degree of statutory independence for the Riksbank. Among other things, the status of the governor must be clarified so that he/she can be dismissed only on grounds of serious misconduct. Neither shall the Riksbank be allowed to accept instructions, except in statutory form, from others, including the government. Moreover, our governing board includes members of parliament; this is a traditional practice in Sweden but not in Central Europe, where it is perceived as a risk of monetary policy being directed politically.

EMU's effects on the financial sector and securities market

EMU is usually discussed and assessed from a macro-economic perspective, not least because the convergence criteria are formulated in such terms. But EMU is more than macro economics - it also entails new infrastructures, increased competition and structural changes. These, as it were, micro-economic effects will be at work in every part of the economy. Here, too, is where EMU can enhance growth and there is reason to suppose that this potential is greater than many expect. In that a new currency affects the very core of a financial system, its consequences will naturally be particularly marked in the financial sector.

Some tendencies

Many tendencies after the euro's introduction will be much the same as those that are already at work and which probably would have prevailed even without EMU. In other words, the overriding tendencies are being driven by other factors, too, and have to do with market deregulation and general internationalisation since the mid 1980s. Two examples are information technology and the internationalisation of saving. Everything points to a continuation of the financial markets' rapid development, with new instruments, cross-fertilisation and a concentration of some specialist functions. Competition in traditional banking is likely to go on tightening, accompanied by rising long-term demand for financial services and increasingly sophisticated customers, be they firms, local authorities or households.

Full-service banks have already become fewer but larger. No doubt one can also expect a continued growth of niche banks and other financial enterprises that concentrate on a small selection of services or outlets. The downward tendency in traditional bank lending and deposits is likely to continue, accompanied by an increased supply and demand for market-based instruments.

There is also reason to assume that some of the financial markets' products will be dropped and new ones introduced. Examples of the former are intra-European currency forwards and swaps. Moreover, according to the International Securities Market Association (ISMA), the changeover to euro will dispense with the need for internal risk management and systems for managing intra-European exchange risk. On the other hand, new products may be created, such as euro options, euro forwards, share indexes for the euro area and euro-designed settlement systems. We cannot foresee what will happen in detail; this field will be largely driven by the market.

The intrinsic importance of EMU for the whole of this transformation is debatable and can hardly be singled out and measured in advance - perhaps not even afterwards. It can of course be argued, with good reason, that the primary driving forces are global integration and the EU's inner market. Still, EMU will very probably accelerate and accentuate this development.

Capital markets in Europe are fragmented at present. Domestic banks and insurance companies dominate in most countries and Sweden is no exception. The background is not just the existence of different currencies but probably still more the tendency for customers to stick to the banks they know, together with the banks' accumulated fund of knowledge about credit risks and local markets.

Except for the introduction of a single currency, the arguments in favour of a national base for operations will continue to apply with EMU. Combined with language difficulties and cultural differences, this suggests that the development of financial "retailing" and its structure will be directed mainly by factors other than EMU. In time, however, the countries with a single currency can be expected to become increasingly integrated, including their financial structures. But in the case of corporate services - particularly for large companies - there is reason to believe that the effects may be fairly big quite soon.

For our situation report on the changeover to euro we also got in touch with a number of house mortgage institutions to see what the changeover might imply for the housing bond market. Opinions differed, however, and the matter had not been considered in any detail. In the case of loans provided before 1st January 1999, a number of institutions considered that conversion would not be necessary. Notification would therefore be done in kronor up to the introduction of euro notes and coins. After that, conversion would be arranged all at once but the physical reformulation of house mortgage contracts would probably be deferred until a change in loan terms. Another opinion, however, was that conversion could be arranged as early as in the changeover period, so there does not appear to be a consensus. In the case of new loans, on the other hand, it seems that demand for kronor loans is expected to fall sharply right from 1st January 1999. These matters require further discussion.

Increased importance of credit risk

In general and on account of economic convergence and a single anti-inflationary monetary policy, the monetary union will cause interest rates in high- and low-rate countries to converge. The absence of an exchange risk premium inside the euro area will also contribute to this. What will remain, even after the changeover process has been completed, is mainly liquidity and credit risks.

As regards risk-free securities, such as sovereign paper, the convergence of interest rates, at least at the short end, may be virtually complete. One reason for this is the need for sound government finance.

With no exchange risk and a tendency for investment decisions to focus more on credit risk, it seems likely that well-developed and integrated European markets will be established for various types of bond, e.g. corporate bonds and municipal bonds. Another contributory factor here is that investors will probably be interested in spreading risk by diversifying portfolios across more countries, thereby limiting losses in the event of an asymmetric shock. It is worth noting here that a company might then have a rating that differs from that of its home country. A company, let us say Volvo, could have a higher rating than the Kingdom of Sweden.

Markets larger and more liquid

In Sweden today there are about 9 million potential investors. In the EU area there are more than 370 million. In addition, investors from other countries in Europe and the rest of the world can be expected to enter this new, large market. The euro will become one of the three major reserve currencies, together with the dollar and yen. Via growing competition, a larger market normally results in lower costs, better borrowing facilities and increased liquidity. It is difficult to avoid the conclusion that this will also benefit the market for housing bonds.

The currency union is accordingly likely to provide borrowers with a larger market in which to operate. There will also be more investors and with no exchange risk, portfolio diversification will be cheaper for them. This should create good conditions for borrowers to find attractive financing, for instance via the bond market. In the case of the residential sector and housing finance, there is particular reason to mention the effects of the lower and more stable interest rates that EMU, all else equal, will lead to. This should result in higher real estate prices, increased residential construction and thereby a greater demand for financing.

For borrowers in this new European market it is probably highly important to adapt promptly to international market standards for economic presentations and financial accounts. This includes the acquisition of an international rating. Borrowers who manage this will probably have an advantage over others. Those with a stable economy will, as always, be in a better position to reap the benefits. Another factor in this competition will be the credit rating of the home country.

Foreign creditors are already increasing their activities in Sweden. A good example is the recent establishment by the French municipal bank, Credit Locale de France. But other foreign banks - Norwegian, Danish, Finnish, British and American - are also reinforcing their positions in Sweden. Together with banks in EMU countries being able to supply credit to Swedish borrowers without any

exchange risk, this will lead to increased competition in Sweden and thereby to generally better borrowing terms.

The changeover process

The process of actually changing to the single currency involves converting the financial instruments as well as the infrastructure in which they are handled.

Taking the instruments first, the countries in the euro area may, and should, denominate new sovereign issues in euro. Other issuers, not least housing intermediaries, should likewise start using the single currency without delay. A member state wishing to convert its outstanding debt into euro will be allowed to do so.

As to the infrastructure, the institutes mainly affected are, for securities, the Stockholm Stock Exchange, OM and the Securities Register Centre, while for the handling of money and payments they are the banks and the Riksbank. In the case of securities, the institutions I mentioned have clearly recommended a big-bang solution - a quick, concerted changeover from kronor to euro right from the beginning of 1999 - because this avoids double systems which, besides being complicated and costly to operate, would be liable to split market liquidity, all of which would render Sweden less attractive as an international financial forum. The Securities Register Centre is also engaged in active discussions with counterparts in Europe with a view to building up a common network for cross-border transactions in securities on the same lines as the central banks' TARGET system for money. This is a complex project, technically as well as legally, and it will not be completed until after the turn of the century; but it is gratifying that the work has begun.

As regards the payment system, I have just mentioned TARGET, the joint network for inter-bank systems based on central banks. At the Riksbank we are making great efforts to ensure that our RIX system is compatible with TARGET. The major work for the changeover lies, however, in the banking sector, with its main stocks of accounts and large volume of transactions.

From 1999 to 2002 the banks will be handling kronor as well as euro. So somewhere in the system there will have to be a conversion mechanism, a scale for translating kronor into euro and vice versa in accordance with the established, locked rate. Bank customers will be able to receive euro and pay in kronor, as well as the other way round, without performing an exchange transaction. The currencies are in fact not two but different ways of expressing exactly the same value - the relationship between the euro and the krona is the same as between a 100 kronor note and five 20 kronor notes.

In principle, the scale function for conversion must be operational right from the start. It will not be necessary, on the other hand, for banks to adapt their internal systems to the euro's introduction either immediately or simultaneously - this can be done to suit each bank during the changeover period. Another advantage of this is that it can help to avoid excessive shortages in the supply of computer and programming specialists.

If Sweden is outside

Sweden may face a situation where, for various reasons, we do not adopt the single currency from the beginning of 1999. Formally, this amounts to much the same situation as at present - the RIX system operates in kronor (even though we incorporate a parallel system in euro), monetary policy is conducted in kronor and government securities are issued in kronor. The exchange risk continues to exist, of course, for loans from the euro area and with it the cost of hedging.

In practice, however, it impairs conditions for Sweden's financial system in several respects. It probably worsens the facilities for handling payments via TARGET. Moreover, as the euro will become a major currency in every respect - it is conceivable, for instance, that a number of large Swedish industrial groups switch to the euro as their group currency - the financial enterprises will be obliged to invest in and run parallel infrastructures. Furthermore, unless it is reasonably certain that the period as an outsider will be short, these investment decisions will be subject to great uncertainty and probably to a financial market of diminishing international importance.

It is certainly true that even if Sweden adopts the single currency we will have to manage double systems in the period 1999-2002. There is a difference, however, in what these double systems entail. If we join the euro area it will be a matter, for one thing, of handling two expressions for a single currency, not two different currencies, and, for another, of doing so for a clearly limited period of time.

Swedish investors will probably be less interested in turning to markets in euro than if we join. But there might be increased investment inside the euro area compared with today. That would reduce the room for investment in Sweden, with negative consequences for the market for housing finance, for example.

Another drawback with not adopting the euro from the start is that Sweden will not have a share of the diversification of foreign investors' portfolios by sectors, borrowers and countries. When Sweden, as I assume, joins the euro area later on, the main opportunity will have been lost; interest in investing in Sweden will probably be weaker in that investors have already diversified.

Summary and conclusions

Most of the evidence today suggests that the economic and monetary union will move to Stage Three on 1st January 1999. For Sweden the question is whether we should join the euro area from the start, wait a while or try to remain outside for good. I hope that we will soon be having a more lively debate on this very important issue. The discussion should cover more aspects than monetary policy autonomy. It is not just a question of economic arguments, though we do consider that these arguments point to participation. It is also a matter of EMU being an important component of the European cooperation in which Sweden is already taking part.

– Outsidership makes demands

From the discussion one sometimes gets the impression that as an outsider, Sweden's path would be easy. Without this European cooperation, we would avoid all the demands for adjustment. That is not the case. In any event we will have to continue to consolidate government finance and create long-term confidence in Sweden's economic stability. This would hardly be easier outside the euro area. As an outsider we will be under surveillance and would therefore have to be "holier than the Pope" in order to fend off problems. EMU does not afford opportunities of trying to solve unemployment with an inflationary economic policy and devaluations but neither do such opportunities exist outside EMU.

– The world will not be the same

Saying no to the single currency is not the same as status quo. The creation of a monetary union just outside Sweden's borders will change the world as we know it. Individuals and firms will both be affected by the euro's introduction whether we participate or not. In our efforts to keep the financial sector informed about EMU we can see that good progress has been made with the preparations. Among those concerned we also experience a strong desire to participate as early as possible so as not to get left behind.

– EMU and Sweden's financial sector

EMU will contribute to increased pressure for structural adjustments and thereby to increased efficiency in every part of the business sector. The same applies to a high degree in the financial sector, including the segment that faces the housing sector. We will be getting a very different supply of agents for borrowers as well as investors. The market will be focused on credit risk and become increasingly transparent, more diversified, more exposed to competition and more efficient.

It is fairly clear that for Sweden's financial sector, an outside position "for the time being" would be detrimental. The doubling of infrastructures would entail additional costs which, together with the uncertainty about the future, would weaken the competitiveness of individual firms and render the Swedish financial market as a whole less interesting for domestic as well as foreign agents. To this must be added the risks of more or less explicit discrimination, for instance as regards access to TARGET.

– Continued preparations

Irrespective of the political discussion, the practical preparations have to go on. The EMI will continue to work on questions that have still to be resolved and we will continue to participate in that work. In Sweden, the Government Office will continue to spread information about its plans and we will continue our cooperation with the financial sector. In the autumn we aim to produce a new report on the EMU preparations. When the Riksdag has decided whether or not Sweden is to adopt the single currency we will also be in a position to say which preparations will be needed more clearly and unequivocally. We face a dynamic process in the world around us as well as in our own country.