Speech

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EMU and the central banks

What happens on 1st January 1999?

First a word of thanks for the invitation to talk about EMU and what will happen in European central banks at the beginning of 1999.

January 1st 1999 will probably be the starting date for one of the most far-reaching projects to have been carried out in Europe in the economic domain. A number of countries will replace their national currency with the euro and adopt a single monetary and exchange rate policy. EMU is a project that has many different dimensions.

Firstly, EMU is a political project in the sense that the introduction of a single currency calls for political decisions. For a variety of reasons, moreover, EMU is on many countries' political agenda.

Secondly, EMU is a macroeconomic project in that the convergence criteria spell out the terms for the macroeconomic trend in potential member states. Much of the public discussion, not least in the press, has in fact focused on identifying the countries that can be expected to fulfil the macroeconomic criteria for EMU participation.

Thirdly, EMU involves the establishment of a new financial infrastructure in Europe. The implementation of a European monetary policy presupposes standardised rules and a uniform system for transactions. This means that EMU is also a further step on the road to setting up the internal market.

January 1st 1999 will mark the finish of much of the very extensive preparatory work that has been needed to make the project feasible. Many aspects of this work are already nearing completion and a lot of systems have reached the testing stage. But after 1999 it will still take a couple of years to bring about the entire

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changeover, not least as regards the introduction of euro notes and coins. Everything is to be completed not later than the beginning of 2002.

In my talk today I shall be reviewing EMU and its various components, with particular reference to institutional and technical aspects. This will include an account of how the future central bank cooperation will be directed and function. Finally I shall say something about how EMU is likely to affect segments of the financial market.

Sweden in the euro area in 1999 or not

There are many indications that Sweden will not be joining the euro area from the start on 1st January 1999. A final decision is to be made by the Riksdag (Sweden's parliament), probably this December. A decision not to participate from the start does not mean that we in the financial sector will be able to ignore EMU and simply carry on as before. The advent of the internal market and the establishment of EMU are matters with fundamental repercussions on operating conditions in the financial sector of every European country, regardless of whether or not the euro is adopted from the start. There is therefore every reason to continue actively to follow the course of events and adapt operations of various kinds to the commercial requirements that are being fashioned in Europe's new financial infrastructure.

Preparations in Sweden

The Riksbank has been working on practical preparations for EMU for some years. This has been done so that we would be ready if the Riksdag were to choose to join from the start in 1999. Even though it now looks as though Sweden will stay outside the euro area at the start, the establishment of the monetary union will entail changes for Sweden. The financial sector in Sweden appreciates this and has made preparations to cope with the new competitive situation. It will be able, in other words, to provide euro services for customers that want them when the union is a fact. This will require parallel systems for krona and euro transactions, which means additional costs.

Besides the macroeconomic criteria and the technical preparations, the Maastricht Treaty requires that member states make their central banks independent. In Sweden, five of the political parties in the Riksdag have concluded an agreement to make the Riksbank more independent. The objective of price stability is to have the force of law. Under normal circumstances neither the Governor of the Riksbank nor the other five members of the new Executive Board are to be dismissed during their six-year term in office and monetary policy is to be conducted independently by the Executive Board. In future the Governing Board will consist of 11 delegates with 11 deputies and have a controlling function.

The question of how the Riksbank and the financial sector will adapt to a conceivable situation in which Sweden is outside the euro area is to be considered in more detail in a report that the Riksbank will be compiling this autumn in cooperation with the financial sector.

EMU's components

EMU's structure can be likened to a building

The Maastricht Treaty is the foundation on which the whole construction rests. The principles for the entire project are enshrined in its provisions. Next come the blocks that make up the building itself. What are these?

Single currency

A most important building block is, of course, a single European currency. The euro will be introduced as a separate currency on 1st January 1999 but notes and coins denominated in euro will not be put into circulation, in the countries that then make up the euro area, until late in 2001 or the beginning of 2002. For a period of not more than 6 months national currencies will be in use side by side with euro. The timetable for the replacement of notes and coins is to be decided by each country. For practical reasons the Riksbank hopes that the changeover can be completed in less than six months, if and when Sweden has joined the euro area.

Monetary policy

A single currency presupposes a single monetary policy; responsibility for this policy will rest with the European Central Bank (ECB).

The European System of Central Banks (ESCB), which is composed of the ECB and the national central banks (NCBs), is to be set up as soon as the countries that will constitute the euro area have been decided, which is planned for April/May 1998. The ECB will have three decision-making bodies. One is the *ECB Governing Council*, made up of the ECB Executive Board together with the central bank governors of countries participating in the euro area. Each central bank governor is to have one vote, which means that, formally, no governor exercises more influence than the others. Moreover, decisions are to be made on a factual basis with reference to the monetary union as a whole, not in the light of national interests. The primary task of the Governing Council will be to formulate monetary policy. Council decisions will then be implemented by the *Executive Board*, composed of the ECB President and five other members, whom the Treaty states are to be "appointed from among persons of recognised standing and professional experience in monetary and banking matters". Their term of office is 8 years and is not renewable. The long term is intended to promote ECB independence.

The *ECB General Council* includes the central bank governors of all EU countries and will exist as long as there are member states outside the euro area. It will prepare for the participation of such member states. These countries with thus be involved in the work on a number of matters that will affect them once they have joined the euro area but will not take part in decision-making. Neither will the General Council exercise any influence on the single monetary policy. The General Council will, however, be informed of decisions by the Governing Council but not of decisions by the Executive Board. Member states outside the euro area will thus have relatively little influence, few rights and numerous obligations in that in practice they will have to follow ECB policy in many respects without being in a position to affect it.

The objective of the ECB is to be price stability. The instruments available for this purpose are a matter for the ECB to decide as soon as it has been established in 1998. In all probability they will consist primarily of open market operations, accompanied by standing facilities and possibly also minimum reserve requirements. Only countries that join the euro area from the start will be in a position to influence the construction of policy and the choice of instruments. The technical construction of monetary policy is to be finalised as soon as the ECB has been established.

As monetary policy in Sweden is already based on the objective of price stability, participation in the euro area would not entail any change in this respect.

Technically, the establishment of the ESCB and the ECB also calls for what might be described as a large-scale merger of the national central banks. The ECB is to be a legal entity with its own capital and foreign reserves, etc. All NCBs will have a stake in the ECB at the same time as the ECB's existence will affect each NCB's earnings. One of the issues that must then be resolved is how today's monetary income at national level is to be managed in the future with a single currency and a single monetary policy.

The capital of the ECB is to be 5 billion euro; Sweden will subscribe not quite 3 per cent, or about 145 million euro, which today is equivalent to about SEK 1.2 billion. The ECB is to have foreign reserve assets up to the equivalent of 50 billion euro. If and when Sweden joins the euro area, contributions will be made in accordance with our share of the ECB. Interest income will likewise be paid back in proportion to this share.

Foreign exchange policy

The monetary union also entails a single foreign exchange policy with countries outside the euro area. The implementation of this policy is to be the ECB's responsibility. If the euro were to have a fixed exchange rate with third country currencies, the construction of the system would be decided by the Council of Ministers. With a flexible exchange rate, which seems more likely, the Council may draw up general foreign exchange policy guidelines, subject to the provision that the guidelines must not conflict with the ECB's price stability objective.

As regards EU countries that are not participating in the euro area, there is to be a new fixed exchange rate mechanism, ERM II; this will replace the existing ERM system and function in much the same way. Membership of ERM II will be voluntary but even if a country refrains from joining, it must still treat its exchange rate policy as a matter of common interest. The aim is to prevent non-euro member states from obtaining undue competitive advantages.

The fundamental elements of the new exchange rate mechanism were established at the European Council meeting in June 1997. Among other things, central rates are to be defined vis-à-vis the euro instead of between all the participating currencies as at present. A fluctuation band of ±15 per cent around the central rates is to be permitted. The central rates will be set by the ECB and the finance ministers of the euro area member states, together with the central bank governors and ministers of the countries participating in ERM II.

Payment system

Another important building block in the EMU mansion is a reliable infrastructure for payments and monetary policy transactions in the euro area. The impact of policy on interest rates must occur simultaneously throughout the area. TARGET, the new European payment system, will make this possible. It provides a network that links up all the national banking systems for large-value payments. All participants in the national systems - in Sweden the RIX system - will be included. TARGET will also be available for commercial payments but this does not mean that central banks will have a payments monopoly in EMU. The banks will be free to use other alternatives, for example correspondent banks. The speed and reliability of TARGET, together with its price, will determine the extent to which banks and other enterprises use it. The TARGET pricing policy is to be based on full cost recovery. All EU national central banks are to have access to the system, whether or not their countries are in the euro area.

It is not yet clear, however, whether non-euro countries will be allowed to participate on an equal footing with those in the euro area. There may be restrictions on, for instance, intraday borrowing in euro to parry fluctuations in the flow of payments. The argument for such restrictions is the risk of intraday credit turning into an overnight overdraft, thereby affecting overall euro liquidity and the interest rate. In Sweden we do not consider that this risk is a real problem. A final decision on the matter will not be made until the ECB has been set up.

Collateral

A single payment system and a single monetary policy presuppose the feasibility of monetary policy operations in securities issued in different countries. These securities must also be acceptable as collateral for loans from central banks outside the country of issue or deposit. There will be two categories of assets that are eligible for monetary policy operations: tier one and tier two. The tier one list consists of assets which fulfil eligibility criteria that are uniform throughout the euro area, while the tier two list consists of additional assets of particular importance for national financial markets, with eligibility criteria set by the NCB in question. Both types of asset are acceptable as collateral in monetary policy operations except as regards outright transactions, for which only tier one paper will normally be accepted. Both categories are also eligible as collateral for cross-border transactions inside the monetary union, though this may not apply to tier two assets if the issuer is located outside the euro area. The question of whether housing bonds should be eligible as tier one assets is still being discussed in the EU and Sweden argue that they should. A decision is still pending.

"Legal system"

Continuing with my account of EMU as a building, the legal structure of EMU can be likened to the plumbing - something that is present in every location and functionally essential. It does not attract much attention until things start to go wrong. The monetary union simply would not work without a legal structure and this has to be "watertight" in order save the inhabitants from chaos. A legal framework is needed for the adoption of the euro. This is partly provided in two Council Regulations, of which the first establishes that legally the euro is to be the

Union's currency right from the start and accordingly replaces the national currencies as of 1st January 1999. Moreover, substituting the euro for another currency is not to constitute grounds from annulling contracts; contractual continuity is thus to apply. The other Regulation mainly addresses changeover issues in the period 1999-2002 with a view to permitting a speedy introduction of the euro. For example, no one is to be prevented from using euro in this changeover period but neither is anyone to be forced to do so. It is also envisaged that euro-area countries will denominate all new treasury issues in euro. A member state wishing to redenominate its outstanding debt in euro will be allowed to take the appropriate measures. All private economic agents are to be free to choose when to move to euro during or at the end of the changeover period.

Legal regulations are also being drafted on, for example, collateral, securities systems, payment systems and monetary and exchange rate policy operations.

What will happen in the ECB and the NCBs on 1st January 1999?

In the first place the exchange rates will be locked and the euro will become an independent currency. From then on the national currencies will be no more than national expressions of euro. The implementation of the single monetary policy in euro will commence via TARGET. In this context the NCBs will function as extensions of the ECB. For banks and financial institutions that already participate in the NCBs' monetary policy operations the changes will not be all that great. But the intraday market will be considerably larger and potential counterparties will be located throughout Europe.

The merger process I mentioned earlier will be undertaken. The NCBs will have transferred foreign reserves to the ECB so that foreign exchange policy vis-à-vis third countries can be conducted right from the start of Stage Three. We do not yet know anything about how foreign exchange intervention will be arranged. It can be either decentralised through the NCBs acting on behalf of the ECB or centralised to Frankfurt.

The NCBs are to keep the ESCB continuously supplied with statistics and analytical material to ensure that the ECB can perform its tasks.

... and in the NCBs of non-euro countries?

National monetary and exchange rate policy will continue to be in the hands of the NCBs. For a country that participates in ERM II, instead of the present system of exchange rates with each of the participating currencies, the currency will be directly linked to the euro. As the degree of convergence between countries is now better than earlier in the 1990s, the risk of tensions will presumably be somewhat smaller than in the present system.

Member states outside the euro area and not participating in ERM II will still not have complete autonomy in foreign exchange policy. The Maastricht Treaty stipulates that they are to treat exchange rate policy as a matter of common interest.

There will be no major formal difference from how the Riksbank operates in practice today. The RIX system will continue to operate in kronor but with a parallel system in euro. The financial sector in Sweden will have an opportunity of making speedy and reliable payments through TARGET. The financial sector will continue to be under an obligation to report statistics, in principle to the same extent as if Sweden joined from the start in 1999.

Consequences of EMU for Europe's financial sector and securities markets

Major changes are in progress in the structure of Europe's financial system. The forces behind them include technical innovations, altered government regulations and globalisation. This general process is being intensified and accelerated by the establishment of EMU.

The monetary union will probably lead to interest rate convergence in Europe. This has to do with the trend to economic convergence and with monetary policy's emphasis on combating inflation. With the single monetary policy and the absence of exchange risk, the remaining interest rate differentials between different countries' treasury paper will primarily reflect other types of market assessments. It is conceivable, moreover, that there will be more room for borrowers other than governments and housing institutions. The supply of securities is likely to become more differentiated. The financial products will change and some will disappear, for example currency, forward and option instruments in the currencies that are replaced by euro.

The move to Stage Three will produce a single European money and capital market that is both larger and more liquid than any of today's national markets. This will probably involve increased competition between the institutions that are active in these markets. Borrowers will find it easier to obtain attractive financing via the bond market, for example. One reason for increased competition between institutions in the euro area lies in the loss of the advantage of a domestic currency and the necessity of sharing the new "domestic currency" with a great many European competitors. It will therefore be important for the financial institutions to establish a presence in the single market early on so as not to risk losing customers. Even if Sweden is outside the euro area, this will still apply to our financial enterprises. A part of their operations may then be transferred to existing branches and subsidiaries abroad in the future euro countries. The future construction of the TARGET system, for example, is important in this respect.

Well-developed transnational European markets may emerge for different types of bond, e.g. corporate, housing and municipal bonds. Part of the explanation may be that investors are interested in spreading risks by diversifying portfolios across countries. The risk of losses can then be limited in the event of asymmetric shocks.

The Swedish market will be affected even if Sweden does not adopt the euro from the start. EMU implies fewer restrictions on cross-border investment and this will hold good for Sweden whether or not we join the euro area.

The Swedish bond market is dominated by housing paper in addition to treasury bonds. In terms of the amount represented by the total stock of bonds, Sweden is around fourth in Europe. Residents account for much the largest share of investment in Swedish housing bonds, though foreign creditors have been more active in recent years. Whichever way one looks at the figures, the Swedish financial sector is rather small in a European context.

Customers in the financial sector may want to have euro services, e.g. euro savings accounts and euro pension accounts. A demand for loans denominated in euro may also arise. Swedish financial institutions have expressed concern that their competitive position may be impaired relative to the European banks that have euro-based deposits. This is one of the costs of being outside.

Securities market

Europe's bourses have announced that securities trading will change to euro in those countries that join from the start. Moreover, the changeover will be a Big Bang - in principle, all trading will shift simultaneously from national currencies to euro from 1st January 1999. The stock market is expected to become larger, with the emergence of one or a few dominant markets for European stocks with the highest turnovers.

Even if Sweden stays outside, there is still likely to be a changeover to euro for trading in some shares on the Stockholm Exchange. This is probably essential for the maintenance of a competitive market place. Nonresident customers account for one-third of the Stockholm Exchange's turnover and Swedish investors trade to the same extent on exchanges abroad. The securities sector therefore foresees a large demand in euro for the most traded shares right from the start, even if Sweden stays outside in 1999.

Summary

The run-up to Stage Three has begun. Sweden is a qualified candidate if we wish to join in 1999, which at present seems highly uncertain. The monetary union will have major consequences for every EU country whether or not it participates from the start.

Consequences for Sweden of staying outside

- The need to combat inflation will remain, along with budget restraint; the degree of freedom will not be greater.

- Less influence in that we will not participate in the construction of EMU's operations in the initial, formative stage. Also a risk of losing influence in other European negotiations because we do not belong to the "inner circle".

Consequences for the financial system

- **On the one hand,** Swedish banks, the Stockholm Exchange, the Central Securities Register (VPC), etc. and other enterprises must be prepared to offer euro services and euro accounts if the market wants them. Duplication in kronor and euro involves additional costs and competitive drawbacks in relation to euro-area banks.

- Swedish financial institutions face the challenge of not getting left behind in structural changes if these are concentrated to euro-Europe. They will be operating in a smaller market (Sweden) than institutions located in the broad euro market with access to the single monetary policy, etc.

- Swedish banks have access to TARGET, like others, but may encounter certain drawbacks depending on the system's construction (overnight loans).

- **On the other hand,** Swedish banks will probably do more exchange trading than if Sweden joins the euro area, and

- Swedish financial institutions and markets can implement the euro changeover more slowly and thereby benefit from experience elsewhere. The same applies to the Riksbank and government authorities, e.g. the National Debt Office and the National Tax Board.

There is some risk of Swedish financial institutions being marginalised and displaced from the heart of the changes. Strong measures are needed to counter this - active strategies on the part of the financial institutions, as well as an economic policy whereby Sweden is attractive for foreign investment. In any event, the authorities, the financial system and the Riksbank must constantly regard EMU as a reality that affects us even if we do not join the euro area.

The Riksbank's work in connection with EMU will therefore not diminish even if the Riksdag decides this autumn that Sweden is to remain outside. Continued EMU work is ultimately a consequence of EU membership, so following the development of the EMU project will remain important.

Otherwise Sweden will miss opportunities of participating in discussions that precede decisions which will determine much of the European countries' economic future. For the Riksbank it is important that Sweden's interests are considered even from an outsider position. It is important that we participate as far as possible in the peaceful revolution that Europe's economy is moving towards.