

Speech

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Future Structure of the Swedish Securities Market

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1. The new world

There have been many, important developments on the financial markets in the past fifteen years. In a short space of time, we have moved from a tightly regulated, decidedly national market to a deregulated market with rapidly increasing international competition. This has gone hand-in-hand with a rapid technical development.

During these years I have personally experienced the first forward transactions in government bonds take place, seen the introduction and expansion of the options market, and the abolition of share certificates and the disappearance of floor-trading on the stock exchange. Moreover, substantial parts of the financial regulatory framework have undergone radical change. Since deregulation came relatively late in Sweden in an international perspective, it has to a large extent been a process of catching up. We have also done so, but nothing lasts for ever. Today's discussion is about how we are to continue to develop well.

Today, we have then a free trade market in the financial sector, of basically the same kind as we have had for a long time in manufacturing industry. The benefits of this are also basically the same - more specialisation, increased efficiency and, in

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the final analysis, increased welfare. The same applies to its cost - large-scale, rapid changes which can sometimes be painful or at least confusing for many people.

In this context, it may be worth pointing out that the financial sector is a sector that produces economic benefits and not one that consumes an economic surplus produced elsewhere in the economy. I am fully aware, however, that there are one or two people who think differently, at any rate outside this room.

The financial system plays a central role in every economy where barter has been abandoned as the predominant form of economic exchange. It can be said that the financial system has three main tasks:

to supply payment services,

to transform savings capital into investments, and

to enable households and companies to deal with economic insecurity and risk.

The financial system functions as a lubricant for the entire economy. A well-functioning financial system reduces the costs and risks of the production of goods and services, thus promoting growth and employment. In a similar way, disruptions in the financial system's functions can have negative consequences for the entire economy. Crises in the financial system can lead to economic development fastening in a vicious circle of falling production, rising unemployment and deflation.

I think it is important that we note and communicate this - to be self-critical, we have not always been so good at this in the financial sector, and the task was naturally not made easier during the financial crisis and its after-effects. However, it is quite definitely a problem that financial activity is depicted as something incomprehensible for the man-in-the-street and we have a responsibility here ourselves. It is not possible to explain everything in ten seconds, but most things can at least be described in a reasonable way if the effort is made, and it is important that we all do this in various contexts.

My thesis is that the most fundamental change that has taken place on the financial markets is that **free trade** has now also reached this part of the economy. How should we tackle this situation? Sweden is a small country with a small economy and we cannot be best at everything. Here in the same way as in industry, we must see what we are good at and develop it. The next question - and this is where we as an authority come into the picture - is whether there are obstacles for this which we can remove or, at least, reduce.

Financial markets have historically mainly been nationally defined and related to the size of the domestic economy. In view of the size of the Swedish economy, we are somewhere in the middle of an EU order of precedence, but in most cases far under the large countries - the turnover on the stock exchange is around eight times larger in London than in Stockholm, issues of interest-bearing securities are four times larger in Germany than in Sweden, to name two examples. An exception to this pattern is the derivatives market, where we occupy fourth place in the EU, which shows that product development can pay off.

In a Europe with free capital movements and free right of establishment, this means that there will always be competitors or potential competitors acting on a market larger than our own. In this perspective, the conclusion will also be that the competitive picture and the approach taken to competition issues will be quite different depending on whether a national or a European approach is adopted. Given the development tendencies that I have indicated, my view is that we should

adopt a European or, by extension, a global perspective when discussing developments in the Swedish financial sector. This approach in no way excludes Swedish solutions, but it is necessary to bear in mind that the conditions for activities in future will be quite different than in the closed and "home-crafted" world which prevailed earlier.

2. Review the infrastructure

The first question we must ask is, of course, whether it makes any difference where financial activity takes place. Is it a good thing if transactions take place here in Sweden? Would it not be just as well if they took place abroad? Technically, financial transactions can now take place practically anywhere in the world. How can you define where a transaction takes place on Internet and does it matter ?

However, financial transactions do not just involve technology. They also involve information, contacts between people and the development of knowledge about financial technology. I believe it is valuable for a country to, so to speak, have these functions at home, even though, in a technical sense, the concrete operations take place elsewhere. I believe that a country with a liquid domestic risk capital market has a better initial position with respect to the provision of capital to the business sector than countries which lack such a market, to give an example. A viable financial market moreover provides spin-off effects for employment and production in related sectors, such as within the IT sector. Sweden is well to the fore with respect to technical development, and has a developed tradition and a good educational level in the financial sector. This also provides us with a platform for the future. To put it briefly: to retain and development competence within the financial sector is, in my view, beneficial for the country's economic development.

How should we then make use of the potential we have ?

In order for a relatively small market such as the Swedish to be able to compete, it must appear attractive in comparison with competitor countries. The market should have a high liquidity and a well-functioning infrastructure. In order for the securities market to be able to function, there must be an infrastructure which, in a simple way, makes it possible for buyers and sellers to meet. This infrastructure includes a number of connected parts which are interdependent in various ways.

The methods, regulatory framework and the capital stock required to handle information, matching of transactions, transfer of ownership rights and registration and payment constitutes in a broad sense what we can call the financial infrastructure. With today's technical development, this infrastructure consists to a large extent of computer systems of various kinds. The development of the financial infrastructure today is therefore very much about computer systems, who has access to the systems, how they communicate with one another and who owns them. Computer systems are then combined with the legal frameworks in order to define the financial products and chains of transactions. When financial products are created in this world, four factors are of decisive significance.

- The costs of carrying out financial transactions may not exceed the costs on competing market places.

- There must be not be any obstacles or as few obstacles as possible for an actor to be able to gain access to the market place. This applies both to different types of actors as between countries.

- The choice of transaction technology in the whole chain of transactions must maintain a high international class and be based on international standards.

- Knowledge about financial products, product development and the financial regulatory framework must be at a high international level.

The Swedish market must to put it simply appear as easily accessible and efficient. If it is technically difficult and expensive to use the Swedish market, it is relatively easy for both foreign and Swedish actors to find an alternative market or for foreign investors to find substitutes for Swedish investments in their portfolios.

Taken individually in an international perspective, the four central infrastructure systems on the Swedish market, The Stock Exchange, OM, the Securities Register Centre (VPC) and RIX, are relatively well to the fore. Taking into consideration the international development, it is, in my view, necessary to review the technical integration between systems to ensure a positive development of the Swedish financial market. An integration of the whole chain of transactions - settlement, clearing, closing and account keeping - would simplify access to the Swedish market and thereby reinforce competitiveness, as well as contributing to a welcome reduction of risks in the financial system. High security both operationally and in terms of risks is a competitive factor in itself. Development is increasingly moving in the direction of developments in real time which affects the entire chain of transactions. This in turn requires technical co-operation to become a reality. At the technical level, I also believe that it is important to find forms to complete the dematerialisation on the securities side so that we no longer need the manual securities processing .

A successful integration is not simply a matter of "linking up" technical systems. It also involves systems of rules, issues relating to access and supervision where the basic aim is to ensure a good, transparent risk management. This is far from uncomplicated, but it is important that discussions take place - we are ourselves discussing this type of issues, *inter alia* with respect to how we can better integrate our RIX system with VPC (the Securities Register Centre).

A few months ago the Ministry of Finance made a number of proposals relating to the stock exchange, including a recommendation that direct access to a stock exchange shall be possible, i.e. if certain requirements are met, it should not be necessary to be a securities institution to be able to trade on the stock exchange on one's own account. This issue has aroused some strong feelings. Nevertheless, I believe that it is good that we now have started to discuss this matter. Given today's technology and the ongoing development, direct access seems reasonable in my view. Moreover, I believe that it can contribute to a better and clearer price formation for this type of financial services. If trading through intermediaries is not absolutely compulsory, a system is created which clarifies the additional value that intermediaries must create in order for this transaction channel to be selected.

3. Promote free trade

Not least as a small country, it is important that we promote and try to further advance free trade. It is a good Swedish trade policy tradition which we should also apply in this field.

I would like to name two, partly related areas, where we at the Riksbank have been active. One concerns the lending of the central banks against collateral in foreign securities and the other relates to the future EU payments system Target.

The question of "foreign collateral" has been discussed both in a Nordic context and in EU circles; in the latter case, it is in an EMU perspective clearly necessary to be able to use paper that exists in one part of the union, let us say Germany, in order to obtain credit at, for instance, the French central bank. Apart from the purely technical problems of such a transaction, which are, of course, considerable, it is in my view difficult to see any fundamental problems of principle with such an arrangement - with or without a currency union.

Nevertheless, this has been regarded as very problematic in certain quarters. With respect to arrangements within the EMU, for example, it is to be the case that securities as an absolute minimum requirement shall have been issued within the EEA. The question that must then be put is what is of interest when collateral is taken for a loan. It must reasonably be the issuer's credit-worthiness, rather than the country in which the person in question happens to be domiciled or where he has opted to carry out an issue. However, we have noticed that this approach often meets intensive resistance.

With respect to the Target system, the EMI Council has decided that while the banks in the EU countries, which are outside the EMU, shall be permitted to take part in the system, they shall be prepared that access to the so-called intra-day credit in the system may be limited or be wholly excluded. Since intra-day credit from the central banks is "the lubricant" for the payment flows in this type of system, this will in this case make use of the system by the Swedish banks more difficult or expensive. The official argument for this is that intra-day credit to "outs" in certain situations would make monetary policy within the EMU more difficult.

On our part, we consider that we have been able to show that this argument is not viable - such monetary policy effects are firstly improbable, and secondly, it is fully possible to deal with them if they should nevertheless arise. However, the position has none the less been maintained, and submitted to the coming ECB for final decision. In any case: if this approach with restrictions is adopted, it will mean a kind of de-facto protectionism which there is every reason to deplore.

If our analysis of the monetary policy aspects of intraday credits holds, there are really no reasons to restrict participation in a national payment system. As I mentioned earlier, neither do I see any problems of principle in using securities from other countries and in other currencies as collateral for such credits. Taken together, it is difficult to see any obstacles in principle to link together payments systems throughout the world where payments in any currency whatsoever should also be able to be settled at any location. Let me add that this might of course look like a very far-reaching conclusion based on a not too deep analysis. However, these are issues that should be raised and analysed.

Anyway, if something like that came into being, this would naturally entail an improvement in the security and efficiency of the global financial system. Implementing anything like this would, of course, entail major technical and legal difficulties - constructing Target within the EU sphere has certainly been complicated enough. In other words it is definitely nothing that can be achieved in five minutes, but I still think it is worth holding up as a vision. A first precondition for starting to move in this direction is that one knows where one wants to go, and that requires freeing oneself of some earlier ballast.

3. Effects of EMU

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The process of deregulation and internationalisation that we have been engaged in during the past decade is a global phenomenon rather than a European. However, it is clear that integration in the EU in general and in EMU in particular has stimulated this development.

This points to a continuation of the rapid development of the financial markets, including new types of instruments, cross-fertilisation and a concentration of some specialist functions. Competition in traditional banking is likely to be tightened, accompanied by a rising long-term demand for financial services and increasingly sophisticated customers, be they businesses, local authorities or households.

The number of "full-service" banks has already diminished at the same time as they are increasing in size. It is probable that there will be a continued growth of so-called niche banks or financial enterprises focused on a few selected services or channels of distribution. The downward trend in traditional bank deposits and lending is likely to continue, accompanied by an increased supply and demand for market-based instruments.

Some other probable developments are, however, more directly related to the EMU process.

Major markets and new instruments

In the first place, this concerns the establishment of a larger, more uniform market area. Today, there are around 9 million potential investors in Sweden. In the EU there are over 370 million. In addition, it can be expected that investors from other countries in Europe and from the rest of the world will be attracted by this new large market. A larger market normally leads, through increasing competition, to lower costs and increased liquidity.

The currency union will therefore provide borrowers with a larger market to operate in. The number of investors will also increase, and, since the currency risk disappears, it will be cheaper for them to diversify their portfolios. To put it briefly, we will have all at once a much larger and much more liquid European capital market, which could increasingly come to resemble the American in size and character.

Secondly, there is reason to assume that certain products on the financial markets will disappear and new ones be introduced. Examples of products that may be dropped are, for example, intra-European currency forwards and intra-European currency swaps. At the same time, new products may be created, such as euro-options, euro-forwards, share indexes for the euro area, etc. We cannot predict what will happen in detail, of course.

Language problems, cultural differences and differences in market structure and market conventions argue, however, in favour of nationally-based activities continuing quite a long time after the establishment of EMU. This applies especially to the financial "retail trade" in relation to households. In the long-term perspective, the participating countries and markets will move increasingly close to one another in this area as well.

Turning to the institutional structure, it is clear that the EMU has already started to have an impact - we see stock exchange mergers at various places in Europe, and here in Sweden the bank structure is changing. This can also in part be regarded as a taking of position in preparation for coming developments, which has also in most cases been confirmed by the companies concerned.

Increased emphasis on credit risk

In general, the currency union - due to the anti-inflationary monetary policy which serves as a common foundation of the EMU - will cause interest rates in high and low-rate countries to converge. The absence of an exchange risk premium, since there is only one currency in EMU, will also work in that direction. What will remain after full completion of the transition process is primarily liquidity and credit risks.

As exchange risks disappear and investment decisions increase the emphasis on credit risks, it seems natural that well-developed and integrated European markets will be established for various types of bonds e.g. corporate bonds, housing and municipal bonds. The desire among investors to diversify their portfolios to a number of countries to limit risks of losses in the event of asymmetric shocks in any country will probably contribute to such a development.

Consequences for the Swedish securities market

What will then be the probable consequences for the Swedish market, especially taking into account that Sweden will at least initially remain outside EMU? It is not possible to elaborate with precision. Presumably, Swedish investors in general will, to a larger extent, turn to the liquid euro market. Other things being equal, this would entail a reduction of investments in Sweden. The same effect may also arise on the part of foreign investors - there is a risk that Swedish companies will not receive a share of a probable "diversification wave" towards assets where the currency risk has previously been a barrier. If Sweden joins later, there is a risk that adjustments to portfolios will have largely already taken place - and moreover in a "one-sided" way.

Against this background, the challenge for us in Sweden will be to carry out an economic policy that retains and reinforces confidence in the Swedish economy and which makes investment in Swedish assets not seem risky but attractive. In this case, we can still receive a part of this process, notwithstanding an "out position". This once again confirms that remaining outside does not provide scope for inflationary policies.

- *The interest market*

The Swedish monetary and bond market is already highly internationalised. Looking at the Riksbank's so-called Primary dealers and to what extent these carry out business with foreign counterparts, it can be noted that this has increased rapidly during recent years. The foreign counterparts' share increased from 5% to 25% between 1992 and the beginning of 1997.

At the same time as the degree of internationalisation is high and increasing, it is clear that Swedish companies still have a considerable competitive advantage in the Swedish market. They have well-developed channels with a broad spectrum of actors and a thorough knowledge of the market and of the Swedish economy. This advantage would, of course, gradually disappear in the case of entry into EMU.

Today, the most liquid part of the European trade with interest bearing securities is performed through around 20 futures contracts primarily in London. In the U.S. there are only three contracts which comprise the most liquid part of the market. It is likely that we are going to move towards the American situation. It is also probable that we will see a concentration of institutions that dominate the market. In this scenario Swedish financial institutions are going to suffer from competitive scale disadvantages. On the other hand, the possibility of making good local/national credit assessments and valuations will have considerable importance in the light of the probable growth of the European markets for corporate, and municipal bonds and the like.

- *The stock market*

The Swedish stock market is already highly internationalised - today about one-third of the trade is handled by foreign players. A contributing factor to the high degree of internationalisation is that Sweden was the first country that in 1993 allowed remote participation on the Stockholm Stock Exchange (SSE). It took some time before the first foreign player used this opportunity, but today twelve out of forty-five members of the SSE are remote members.

The most important features that the SSE will have to possess to be successful - whether in or outside EMU - are good transparency, low transaction costs, competent members and a high standard of professionalism. In my view, the Stockholm stock market is competitive in all of these aspects.

In order to be competitive in an "out" scenario, the SSE will be forced to quote prices in a number of currencies of which euro will be one. Work is in process together with the Securities Register Centre (VPC) to develop solutions to manage

clearing and settlement in both kronor and euro, as well as perhaps other currencies. A "multi-currency environment" will, of course, affect all players on the market to a greater or lesser degree. As I said earlier, this will entail costs which certain of our competitors avoid. However, at the same time, there may also be a positive aspect in this, in that it places the focus on the importance of creating rational infrastructural solutions.

5. Conclusions

To conclude, I would like to say the following:

The transformation of the financial markets from a regulated and closed environment to an environment characterised by market control and international competition has been good not only for the financial market itself, but also for the economy as a whole. This does not, of course, mean that it has been without problems, but processes of structural transformation are never without problems. For Sweden, it is important in international contexts to defend and advance the positions of free trade in the financial market sector, in the same way as we do with respect to manufacturing industry.

Sweden is not and probably cannot be a globally leading market place. But we do not need to let ourselves be marginalised because of that, even less excluded. What is necessary is that we bear in mind and develop what we are good at. Not least important in this context is to make available an infrastructure of high class both with respect to efficiency and stability.

Making a reality of EMU will further reinforce a number of the developmental features that have characterised the financial markets in recent years. With respect to the infrastructure, the situation will be complicated for some of us in Sweden since we will at least initially be outside EMU. This means that we must develop double infrastructures to a great extent, which will be costly. However, it can hopefully still be turned into something positive in the sense that it assists us to place the focus on the organisation of the financial infrastructure. Let us hope that this can release a lot of creative thinking that will lead to solutions both being better and coming about more rapidly than would otherwise have been the case !