Speech

Second Deputy Governor Eva Srejber

THURSDAY, 29 MARCH 2001

Internationalisation and financial integration

The Bankers' Club – Gothenburg

Thank you for the invitation to come to Gothenburg and speak about internationalisation and the ongoing process of integration in the financial markets.

I intend to begin by putting developments on the financial markets in a historical perspective and then to deal with the forces behind current developments. I shall then focus more specifically on Europe and the role played by the euro and, finally, I shall briefly discuss the important work pursued by international organisations in strengthening the financial system and thus reducing the risk of crises arising.

Globalisation from a historical perspective

Over the past few decades we have seen how the global economy has been internationalised on a large scale and how deregulation and technological achievements, particularly within the IT field, have created new conditions for growth. During the same period, global purchasing power has more than doubled. And it is not only the western world that has benefited from the opportunities offered by internationalisation; many poor countries have managed to climb a few steps up the global income ladder. The Asian 'tiger' economies are good examples of this.

A look back in time shows that this development is not unique. What we can see is that periods of relatively high global growth have coincided with accelerating international market integration, deregulation and a rapid spread of technology, which has enabled poorer countries to draw closer to richer countries. If we go

SVERIGES RIKSBANK

Telephone +46 8 787 00 00 | Fax +46 8 21 05 31 | E-mail registratorn@riksbank.se

back 150 years in time, we find ourselves in exactly this type of situation. At that time, obstacles to trade were being abolished and countries and regions were being united by railways and steamships. Postal systems were developed and the telegraph system made a breakthrough. Intercontinental cables were lowered into the seas to connect Europe to North and South America, Africa and Asia. The world experienced a revolution in transportation and information that has yet to be equalled.

The Sweden of that time is a good example of how a country can make use of internationalisation to lift itself out of poverty. When the country entered the 19th century, it had extensive regulations in trade and industry. However, the process of deregulation of the economy began during the first half of the century, under pressure from the growing markets' need for greater flexibility. The cities' toll gates were abolished and people could move more freely around the country. At the same time, private ownership was strengthened. The foundations were laid for the rapid industrialisation that took place during the latter part of the 19th century, when Sweden joined the global economy in earnest.

We know that there was great mobility within the international economy of that time, described for example in Vilhelm Moberg's books about the Swedish emigrants. Many of us have relatives in the USA as a result of the massive emigration, when more than one million Swedes left the country to seek their living elsewhere. This process was made easier when the obligation to carry a passport was abolished in 1860 and it became easier to move across Sweden's borders. There was also considerable migration within Sweden. Today's labour market cannot compare to this in terms of flexibility!

Another important element in the dynamic economy of that time was the development on the financial markets. The rapid industrialisation of Sweden would hardly have been possible without functioning capital markets that ensured savings were channelled where they were most needed. The deregulation of the Swedish interest rate markets in 1864 was important for this capital transfer, but was not sufficient to enable large-scale industrialisation in Sweden. This required, in addition, access to the international capital market. I shall let the major Swedish railway project began in the mid-1800s explain why.

The state paved the way abroad

Sweden was sparsely populated with vast distances, which made railway construction relatively expensive, compared with large parts of Europe. In addition, the railways tied up investment capital for a long period of time. As there was a shortage of long-term savings in 19th century Sweden, they were forced to seek financing abroad. In 1857 the Swedish National Debt Office ventured out onto the international capital market. The first railway loan was issued in Germany and comprised the start of an era with extensive capital imports to Sweden lasting more than 50 years. This provided Sweden with access to capital for productive investments on a scale that would scarcely have been possible otherwise.

The central government borrowing paved the way abroad for other borrowers, such as municipalities, mortgage institutions and industrial companies. The large Swedish banks were to a large extent given the task of acting as intermediary in bond loans and thus had the opportunity to develop contacts with foreign banks. The integration of the financial markets increased. For Sweden, this meant that our manufacturing companies could make use of the greater access to capital and lower interest rates in industrially-developed Europe. Gothenburg, with its proximity to the British goods and capital markets, played an important role here. For instance, the Skandinaviska Kreditaktiebolaget, which was the country's leading bank during the latter part of the 19th century, had its registered office here. The internationalisation of the financial markets was facilitated by the fact that Sweden joined the monetary co-operation of the time, the gold standard, while the national integration of the markets was strengthened by the fact that the Riksbank was granted a monopoly on issuing banknotes at the end of the century. This also helped to lay the foundation for a more modern monetary policy.

One point of interest is that the railway construction also gave Gothenburgers the decisive influence in determining the time in the 19th century. It was the railways that ensured that the whole of Sweden followed the same time. Prior to the railways, time was determined by the sun. It was 12 noon when the sun stood at its highest point in the sky, regardless of which part of the country one was in. This meant that there was a time difference of 52 minutes between the most eastern and western parts of Sweden. When the western trunk line between Stockholm and Gothenburg was complete, it was necessary to have the same time so that the timetables would work, and Gothenburg time became the standard.

This period of liberalisation and internationalisation of the world economy was abruptly broken off by the outbreak of war in 1914 and was replaced by national isolation. Although Sweden was largely an open economy during parts of the interwar period, it was not until after the Second World War that this isolation was broken at a global level. For the past couple of decades we have been in a clear period of internationalisation and financial integration.

Same driving forces now as then

Today, information technology and communications technology have replaced the railways as symbols for economic progress, but the driving forces are basically the same now as they were then and the interaction between the financial markets and other parts of the economy plays the same important role. The development of functioning markets for risk capital has been an important factor behind the IT revolution, which in turn has been an important requirement for the way in which the financial markets have developed. Thanks to the new technology, capital can now be transferred in seconds from one continent to another. We have obtained a global capital market that brings together borrowers and lenders from all over the world, 24 hours a day, while new financial instruments deal with the risks arising from international trade and investments.

Let me take the co-operation within the EU as an example of the changes occurring in the world today. The work on implementing the single market is aimed at tearing down barriers to the four freedoms, which entail people, goods, services and capital being able to move freely within the union. The increased competitive pressure that ensuing from the deregulation of the single market has led to major structural changes in the EU Member States' economies. The number of mergers and acquisitions on various markets has increased significantly. In the financial sector, the reduction of the number of credit institutes has continued and there are now around 7,500 institutes in the euro zone, which is 3,000 fewer than there were 15 years ago.

The euro has created a basis for an integrated European market for securities. The money market has undergone a fundamental process of integration and standardisation. The deposit market, that is to say, the market for loans without collateral, and the derivative markets were in principle fully integrated at the beginning of 1999. The Eurosystem's refinancing transactions have strengthened the development of cross-border transactions on the money market, while the TARGET system has enabled a balancing of liquidity within the euro zone and contributed to eliminating price differences within various segments of the money market. The stiffer competition, the increased number of counterparties for individual banks and the improved liquidity are other important structural changes that have taken place parallel to the increasing cross-border activities. On the other hand, the integration process has been much slower on the repo market and the treasury bills market.

On the bond market the euro has led to an acceleration of growth. The number of outstanding bonds in private, non-financial companies have increased considerably, albeit from a low level. This increase mainly applies to the large bond loans, that were issued to finance the extensive merger and acquisition activities. However, Europe lags behind the USA, where the market for private bonds is three times as large. On this side of the Atlantic bank loans still dominate, which makes corporate borrowing more costly.

Europe also lies one step behind the USA on the stock markets. However, a clear trend towards increased saving in shares can now be discerned in Europe, too. The change in the national pension systems contributes to this development. The total number of listed companies in the euro zone has increased steadily during the 1990s. This development also applied to the 'growth' stock exchanges. For instance, the number of companies listed on the pan-European stock exchange alliance EURO.NM increased by almost 100 per cent in 1999.

It is not so strange that Europe cannot measure up to the USA on the financial markets, as the integration process has not come as far here. Whereas the USA has a large, integrated market, Europe has many small ones, which are also covered by different regulations. On the other hand, this means that there is great potential within Europe's financial sector. Intensive work is currently in progress to realise this potential. This includes the EU countries adopting a plan of action for financial services, that should be fully implemented by 2005. During the Stockholm European Council last weekend, the Heads of State and Government adopted the Lamfalussy Committee's proposals for a more effective legislation process in the field of finance in the EU. This was a very important decision. Today it takes an average of three years for the EU to make decisions on new regulations. Such a slow process is evidently a problem in the financial field, where development is otherwise very rapid. A regulatory system that does not correspond to reality can lead to both increased risks in the financial system and lower economic growth, as the finance markets' contribution to the rest of the economy will be lower than it could be. There is also a risk that financial operations will simply be moved somewhere else, where the regulations function better.

Role of the krona unchanged
Now that I have discussed the role of the euro in integration of the financial markets in the euro zone, I will take the opportunity to deviate from the subject slightly and mention briefly the euro's role on the Swedish financial market. You will no doubt remember the discussions on the marginalisation of the krona prior to the introduction of the euro in 1999. Some prophets of doom claimed that the krona would not be able to survive so close to such a large currency. Swedish companies and individuals would spontaneously and rapidly go over to the euro. As we now know, this was not the case.

According to the statistics the Riksbank collects on a monthly basis from the Swedish credit institutes, it can be concluded that the krona's share of the total assets has declined slightly. However, it has not been replaced by the euro, but by other currencies, probably chiefly the US dollar. At the end of last year, the euro comprised only 6-7 per cent of the total assets.

The Riksbank's studies also show that the total Swedish activity in euro on the money market is relatively slight and in particular concentrated to the deposit and swap markets. There are still a few programmes of certificates in euro and the secondary trading in euro-denominated short-term papers is very small. On the bond market, there are some corporate and bank bonds issued in euro. However, trade is modest, which is probably due to the fact that it has not been as cheap to borrow on the euro market as was expected. The fact that Swedish companies still choose to seek financing there may be due to the fact that it is the only way for some of them to borrow really large volumes.

Nor has there been any major change in the spot trading in krona on the foreign exchange market, compared with the period prior to the introduction of the euro. The average daily turnover in SEK against DEM during the period 1995-1999 was SEK 19.2 billion. The corresponding figure for 1999 and 2000 was SEK 19.5 billion.

Developments on the Swedish stock market have been similarly modest. Since the introduction of the euro, it has been possible to list shares parallel or exclusively in euro on the OM Stockholm Exchange. During 1999, three companies made use of this possibility. They were Electrolux, Nordea and Stora Enso. Since then, no new companies have registered an interest in being listed in euro and trading in the three already listed companies has been very modest.

The talk of the death of the krona has thus been greatly exaggerated. It is hardly surprising that there was no spontaneous changeover to the euro. This is in fact what we at the Riksbank said when the debate reached its peak a few years ago. At the time, we pointed out that almost 70 per cent of the Swedish national income is comprised of wages. The entry of the euro into Sweden is therefore largely determined by Swedish households. Why would they choose the euro over the krona? There is little incentive to do so, as long as their wages are used for goods, services, mortgage interest payments and other items denominated in kronor. The rest of the national income is the operating surplus generated in companies and that is used to increase the owners' wealth or paid out in dividends. A large number of these companies used have Swedish owners, who cannot be assumed to have any motive for changing over to the euro in the reporting of their balance sheets.

Given this, it is reasonable to ask why we had a debate on the repression of the krona at all. I myself believe that it stemmed from the over-enthusiasm of some EMU supporters. They were quite simply convinced that Swedes would not be able to resist the attraction of the euro. As an EMU supporter, I can of course see the advantages of the euro, but to believe in a general, spontaneous transition would be going too far. This meant that the idea of a 'euroisation' was also a bad argument in the debate prior to the start of the EMU. If the Swedes are to be won over to the idea of the EMU, we should be emphasising the facts. Personally, I believe that it will be easier to arouse interest in a discussion based on facts, when the euro banknotes and coins appear next year.

Globalisation requires stable game rules

After this in-depth foray into the world of the euro, I shall return to the more general issues following on from the current internationalisation process. This creates, as I said earlier, the right conditions for a more rapid economic growth, but it does not offer any guarantee that this will be the case and it is important to remember this.

The Swedish economic crisis at the beginning of the 1990s is still fresh in most of our memories. That experience provided a clear illustration of the importance of pursuing a long-term, credible economic policy. However, it also showed the importance of building up properly functioning institutions to oversee the financial markets when deregulated. In Sweden it was evident that the supervisory authorities were not prepared for the reality that would prevail after the deregulation of the credit markets in the 1980s. Similar conclusions can be drawn from the crises in for example Mexico and Asia. These also show clearly that countries wanting to participate on the international capital markets must meet the requirements for openness and provision of information. This is positive, not only because it facilitates access to international capital, but also because the requirements make it more difficult for the governing elite and pressure groups to line their pockets at the expense of the majority of the population, if they want to take part in international society.

The crises during the 1990s have also demonstrated that problems in one country can spread to other countries at a much greater speed than before. For this reason, some people would like to see an inbuilt time lag in the markets, for instance by introducing a tax on financial transactions, to reduce the damage to individual countries when capital moves rapidly across borders. This idea is based on most of the transactions on the international financial markets being pure speculation. Naturally, there is some harmful speculation that needs to be counteracted, but a transaction tax would probably do more harm than good. It would have a very negative effect on risk management in the global economy. Financial transactions are increasingly taking place between financial institutes with the aim of spreading different risks, that they are paid to take over from their clients. This processing is important to enable international trading to flow smoothly. We therefore need to look for solutions that minimise the risks of financial crises and do not destroy the institutes' opportunities for risk management. In addition, and it is important to remember this, we do not want to remove all forms of speculation. Healthy risk taking is an important factor behind economic growth. So what can we do?

An economic policy that is credible in the long term is, as I said earlier, a very important ingredient in this context. But it is not enough. Rules and institutes that contribute to financial stability are also necessary. This is why international organisations such BIS, IOSCO and the OECD are working to strengthen the financial system in various ways. In total, the work covers a dozen different areas, from overseeing and supervising the financial system to observing individual countries' economies and regulations for credit institutes. Allow me to briefly mention, in this context, the capital adequacy regulations worked out by the Basel Committee, as I feel this is a good example of how we can work internationally to create regulations and institutes that contribute to stability, without preventing the important, healthy risk taking.

The Basel regulations mean in principle that the greater the risk a bank takes, the more capital it should hold. As capital costs money, the Basel regulations lead to the banks reducing their risk taking. This in turn reduces the risk of bank crises and other disturbances that would have a negative effect on economic growth arising in the financial system. If this is to function, it requires a broad geographical support, which it has. The Regulations from 1988 are applied in more than 120 countries. The Basel Committee has proposed new regulations, which are an extension of the current ones. There is no reason to believe that fewer countries should apply the new rules.

The work in the international organisations is laborious and complicated, as there are many countries that have to reach agreement. In other words, it requires both patience and foresight. A large portion of humility is also good, as our knowledge of these issues is limited. As the financial markets are constantly undergoing change, the work on improving their methods of working should be a constantly ongoing process.

Conclusion

Over the past few decades, there has been an extensive process of deregulation in many countries, particularly on the financial markets. And exactly as in the latter part of the 19th century, capital can move more or less freely between different countries. Deregulation has gone hand in hand with rapid technological developments, particularly within the field of information and communication. This has, just as in earlier periods of internationalisation, led to an accelerated global growth. The process has created opportunities for many countries to escape from the poverty trap.

The work on implementing the single market and introducing the euro can be seen as part of the larger international pattern. The deregulation on the single market strengthens competitive pressure and increases flexibility in the European economies. The euro has lain the foundation for continued integration of the financial markets. Sweden is actively participating in the work on developing the single market, but has so far chosen to remain outside the single currency co-operation. It is therefore unsurprising that the use of the euro in Sweden is relatively modest so far.

The main contribution of the finance markets to internationalisation is, as at the national level, to channel capital to where it will do the most good. The rapid globalisation of trade and manufacturing has also created a need for new financial solutions for companies and individuals. This applies in particular to the need to manage the risks arising in international trade and investments. Thanks to IT developments, it has been possible to develop well-adapted financial instruments for this purpose.

At the same time, the integration of the financial markets and the technological developments have meant that financial crises can now spread between countries and regions much more quickly than before. This shows that these markets do not function perfectly. It is therefore important that government and authorities continue to co-operate to create regulations and institutions that minimise the risk of financial crises, without providing obstacles to healthy risk taking, which is necessary for good economic growth in the global economy.