Speech

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EMU—a further step in financial integration

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Stage Three of EMU will soon be here. Something that many people felt was impossible just a few years ago is now taking place. The EMU project is probably the greatest change that has even happened in the domain of exchange rate policy. The economies of eleven countries are being linked together by a single currency. Both the population and the economy of the euro area will be on a par with the United States. Today, the euro area's share of the industrial countries' output is about 30 per cent and the United States has 35 per cent.

The introduction of the euro will affect conditions for the financial system throughout Europe. But the advent of a single currency should not be discussed as an isolated phenomenon in the financial sphere. The move to Stage Three is simply accentuating a process that is already in train. In the 1980s and '90s we have seen the beginnings of a financial revolution on a global scale. This in turn has been a combined consequence of financial deregulation, a general globalisation of trade and production, major developments in technology and new demographic trends.

In my address today I shall be pointing out discernible trends in the development of the financial system and how this process is being reinforced by the coming European Monetary Union. In conclusion I shall consider what this requires of economic policy, its decision-makers and various authorities.

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A financial revolution

It is hardly an exaggeration to say that a revolutionary process of financial transformation and development has got under way in the past decade, with consequences that we probably cannot yet fully foresee. Deregulation, globalisation, advanced information technology and new methods for valuation and risk management have initiated a dynamic process in which financial markets, institutions and instruments are interacting. There are clear similarities with the expansion of real economies in the past hundred years; a stream of new, more efficient and specialised production processes and new communication facilities are leading to a growing volume of trade. Basically, the financial trend and its internationalisation are a natural development of the market economy, a logical consequence of persistently rapid economic transformations that call for new financial solutions for households and firms.

Challenges for banks

The foreseeable developments will alter or at least affect the future role of banks. New trends in traditional banking are already discernible.

Competition for bank deposits is growing in that people are increasingly choosing to place assets in securities, either directly or via mutual funds. Specialised agents of various types, such as niche banks, have also entered this field. Savings instruments that attract customers are even being provided, at least in Sweden, by food chains and petrol companies.

In the case of loans, a growing proportion of credits is being arranged in the securities markets. Then there is more uncertainty about the social security system's future ability to generate adequate pensions. The demographic trends are also entailing changes in saving behaviour; a growing proportion of people in the industrialised world are approaching retirement and are more prone to save than to borrow.

Cross-border investment is rising. People in Sweden, for example, are placing their long-term savings to a growing extent in assets issued abroad. At the same time, nonresidents are increasing their holdings of Swedish financial assets.

Furthermore, technological advances are making it possible to supply traditional banking services without the aid of a large branch network. This in turn makes new banking establishments less costly than before and a bank with just a few branches or a business concept based on telephony or the Internet can gain a competitive advantage in certain segments of the market. Products are also becoming more sophisticated and their construction and production are increasingly dependent on specialist know-how that may become available outside the banks.

The speed of these processes varies from country to country. The structure of bank earnings is already changing, with a growing share from a range of commissions compared with the traditional income from net interest.

There is nothing to suggest that the rate of and pressure from these changes will ease off in the years ahead. On the contrary, international integration seems to be becoming more intense. The establishment of EMU means that this trend will accelerate.

EMU affects the financial system

The introduction of the single currency will affect the financial system in various ways. The most obvious change is the end to exchange transactions between the national currencies in the euro area. This also means an end to forwards and swaps in these currencies. By itself, this will leave its mark on the earnings of European banks.

The coming of the euro will also affect financial activities in Europe more profoundly and may necessitate a number of changes. The euro area will constitute a larger and more uniform market with a population of about two hundred million. This market, moreover, is likely to attract investors from other European countries and other parts of the world.

Via growing competition, a larger market normally leads to lower costs and increased liquidity. With more investors and the elimination of exchange risks, it will cost less to diversify savings by placing them in more countries. In other words, savers in one country will transfer some of their assets to other countries. This process has, in fact, already begun. Briefly, then, all at once there will be a much larger and much more liquid European capital market that in time may resemble the US market in size and nature.

A competitive factor that has been important for national banks—familiarity with their domestic monetary policy—will disappear when the single currency is introduced. This could lead to a centralisation of trading in treasury bonds. It is quite conceivable that in time, treasury bond transactions are concentrated to one or two financial centres in Europe.

The elimination of exchange risk means that risks of other types will attract more attention. I am thinking in particular of liquidity and credit risks. This could well result in the development of trans-national European markets for different categories of bonds, for example, corporate bonds, housing bonds and local authority bonds. A contributory factor here will probably be a propensity for investors to spread risks by diversifying portfolios so that potential losses are limited. Nor is it only trading in these instruments that will be affected. New knowledge will have to be acquired by the various players.

Share trading is already showing clear effects of EMU. Stock exchange mergers are occurring here and there in Europe. Another expression of what is at least a related tendency is remote participation in the national stock exchange. At the same time, the two principal competitive factors in share dealing will continue to apply, namely local customer relationships and knowledge of national accounting, taxes and laws in the company's home country. But even these factors will be modified as investors learn more about conditions in other countries, harmonisation between countries continues and the production of goods and services is increasingly globalised.

Even this very summary review illustrates how the changeover to a single currency in Europe will affect conditions for the financial system. The financial markets will become larger, accompanied by increased competitive pressure. Some activities will be modified or disappear entirely. Others will be concentrated to one or a few financial centres. But there will probably also be some new activities.

These developments will leave their mark even in countries that do not join the euro area but are adjacent to it. This, too, is a process that has already begun. Banks are being merged into large units. Cost-cutting has come to the fore. Modes

of distribution are being overhauled along with a build-up of specialist knowledge. Systems for pricing different products are being changed.

Financial transformation not straightforward

Today there is a widespread conviction that free trade in goods and services enhances prosperity in the long term. In the same way, most things suggest that in time, free trade in the financial field leads to increased economic growth.

But we have also learned that the transformation and development of the financial field are not without problems. In the past decade there have been bank crises in a number of countries as well as several heavy corrections and large fluctuations in money, equity and currency markets around the world.

There is nothing inherently new about financial crises. On the country, they have occurred from time to time for many centuries. Experience shows that free trade and transformations in the financial field require a great deal from economic policy, its decision-makers and various authorities, as well as extensive cooperation between countries. This is all the more the case in that, with the increasingly integrated financial system, mistakes in one part of the world may quickly lead to economic repercussions elsewhere.

Many financial crises in the past decade

The financial problems at present in countries in Asia and other parts of the world are in many respects similar to the situation in Mexico a couple of years ago, as well as to the Swedish crisis in the early 1990s. Financial problems arise in an economy essentially as follows.

Banking involves accepting deposits from the non-bank public and transforming these short-run savings into loans with longer maturities to households and firms. This transformation of maturities is normally an economic benefit for society as a whole. The banks provide payment services and mediate credits.

However, the commercial practice of borrowing short and lending long is associated with risks. If people perceive a bank's position as uncertain and withdraw their savings, the bank will need to obtain liquidity elsewhere; otherwise it will have to suspend payments and ultimately go bankrupt. In the latter event the bank ceases to contribute to the workings of the economy. If this happens to a single bank, the economic consequences may not be serious. If it involves the whole of the banking system, however, economic activity may be profoundly weakened. That is why banking operations need to be safeguarded.

One safety measure is the possibility, in exceptional circumstances, of the central bank intervening as the lender of last resort. This is a matter of providing liquidity—as long as the banks are fundamentally solvent—when the stability of the entire financial system is threatened. In that way it is possible to avoid more serious economic consequences and, provided the problems underlying the crisis are managed, stabilise the situation in the banking system and the economy in general.

However, a central bank's unique possibility of providing liquidity is restricted to the national currency. If a country has an external deficit and revenue from exports does not cover imports, to make up the difference it has to borrow in foreign

currency. The vulnerability this involves increases if the loans are short-term, sizeable and have been channelled via the banking system to long-term investment projects. If a country in this situation encounters problems with the renewal of foreign loans, the central bank will have limited opportunities of coming to the rescue with liquidity unless it happens to have sufficient foreign exchange reserves or borrowing facilities.

That is more or less what has happened in the countries that have recently been hit by problems. Sudden shifts in confidence as to a country's real economy, the value of its assets or its political system are examples of factors that have triggered crises in economies that have been highly vulnerable.

In some countries the State has been able to obtain foreign loans and thereby contribute liquidity to banks with problems. Meanwhile, these countries have made their own efforts to implement confidence-enhancing measures that would stabilise the situation.

Other countries have been obliged to turn to the international community, headed by the International Monetary Fund, for assistance with foreign liquidity. Private banks have also been engaged, as one might expect considering that they are the banks which have exposures in these countries. In return, the countries have been required to take measures so that confidence can be restored. In other words, the underlying problems must be tackled. By itself, liquidity support does not suffice.

The required measures include the orderly winding up of insolvent banks, a clearer account of the problems, a reduction of current-account deficits, a consolidation of government finances so that expenditures for restoring the financial sector can be covered, and a construction of monetary policy that guards against the risk of the country been suddenly hit by massive currency outflows. In such a situation one cannot expected the necessary adjustment to be painless or free from difficult decisions.

Attempts by a country to isolate itself from the international exchange of financial services would probably lead in time to effects on growth and prosperity that are just as disastrous as protectionist measures in other fields. A country that chooses to impose controls for a time would find it hard to re-enter the international credit market once the crisis had subsided. Currency restrictions of the type we have seen some examples of recently therefore lead the country that introduces them into a dead-end.

When problems of this type arise in one country, the effects are liable to spread to other countries. Recently we have seen a global increase in various asset risk premia as a consequence of the turbulence in Asia and the problems in Russia. This has affected countries that geographically are a long way away from the countries in question. A part of the adjustment of risk premia probably represents a normalisation. It is not to be expected that stock markets around the world can generate capital gains year after year that deviate from the long-term development of corporate profits. Neither is it unreasonable that the terms on which countries borrow should become more differentiated than before to reflect the various risks involved. But adjustments of this type are seldom smooth. Exaggerations in one direction sometimes give way to excesses in the opposite direction. The so-called flight to quality that occurs in connection with financial turbulence in parts of the world is a sign that investors want a rapid reduction of portfolio risks. This leads to increases in risk premia.

One way of adjusting portfolio risk is to sell shares and buy treasury paper. That is why financial turbulence often has a negative effect on shares prices, accompanied by a downward movement in long-term—and sometimes even short-term—interest rates. Moreover, in a particular country, even if its economic fundamentals look good, such a situation can give rise to downward pressure on both the exchange rate and share prices at the same time as interest rates rise. That suggests that certain investors are reducing all types of holding in the country in question, which is a signal to the country's decision-makers that more must be done to enhance general economic policy's credibility.

High standard of discipline throughout economic policy

While it is obviously important to discuss how a financial crisis, if it occurs, should be managed, it is at least as important to minimise the risks of a crisis ever materialising. This applies in particular when the financial system is undergoing rapid developments. The transformation in Europe in the coming years must therefore be followed closely.

One key factor is economic policy in general. An economy characterised by low, stable inflation, sound government finances and good economic policy credibility also provides a generally stable economic environment. This in turn promotes a sound development of the financial domain.

By itself, however, this is not enough. Another highly important matter is the appropriate government supervision of the financial sector. Even central banks that are not directly engaged in this supervision must monitor tendencies in the financial field in order to fulfil their primary tasks of ensuring price stability and financial system stability. There are several reasons for this.

Monetary policy is implemented through the financial system's agents. The banks' ability to transmit monetary policy effectively may be jeopardised if they have problems. The central role of the banks in the payment system—as the channel for payments of every type—makes it important that the banks are financially healthy and operate efficiently and reliably. Otherwise the traffic in payments is liable to be disturbed. If the problems become so great as to constitute systemic risk, it is incumbent on the central bank to consider support for liquidity. Moreover, in that central banks provide settlement systems for large-value payments, they also have a direct, operative function in the payment system. All inter-bank payments are channelled through the settlement system, which is thus the hub of the entire payment system.

In Sweden the Riksbank now regularly publishes a Financial Market Report, in which we present our appraisal of the financial system's development and stability. The Report is thus a way of monitoring one of our primary functions—the promotion of a safe and efficient payment system. There are some parallels here with the Inflation Report, which we publish regularly as part of the work on our other primary function—safeguarding a stable value of money.

The rapid pace of financial developments, particularly in the international payment system, also calls for extensive international cooperation. The issue of financial system stability will be up for detailed discussion in various fora in connection with the coming annual meetings of the World Bank and the International Monetary Fund. The central banks also cooperate on matters of this

type in the framework of the Bank for International Settlements in Basle, Switzerland, where representatives of central banks throughout the world meet regularly once a month.

Conclusion

To sum up, the financial system is undergoing a rapid transformation and development. The middle of the 19th century is commonly associated with the industrial revolution. Perhaps future historians will see the late 20th century as the era of the financial revolution. Europe's move towards a single currency will accelerate the trend.

The transformation and development of the financial system will ultimately contribute to future prosperity. But experience has taught us that it is a development which needs to be monitored very closely and presupposes a high degree of discipline in economic policy. It requires a great deal from decision-makers in the political system and the supervisory authorities, as well as from those of us who work in central banks.

Developments in the financial field are creating large opportunities. But it is also important to bear in mind that major, far-reaching changes normally entail risks. In view of these risks, every agent in the financial system needs to act wisely and discerningly. Only in this way can the full benefits be drawn from the opportunities that financial developments are providing.