Eva Srejber: The euro in the euro area and in Sweden

Speech by Ms Eva Srejber, Second Deputy Governor of the Sveriges Riksbank, to the EU Club of Sweden, Gothenburg, 16 October 2001.

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I should like to begin by thanking you for giving me the opportunity to come here and speak about the euro and its usage. The euro is evidently hot news right now, which is probably not surprising when one considers that in just two and a half months' time the 300 million inhabitants in the euro area will be replacing the banknotes and coins in their wallets. On 1 January the euro, which so far has existed asmerely an electronic currency it will also finally exist in the form of banknotes and coins.

A gigantic logistics project

The newspapers have been full of stories about the introduction of the euro for some time now, including fears that the transition to the euro will be a field day for counterfeiters. However, most articles concern the pure logistics behind the transition from the old national banknotes and coins to the new euro ones. It is not surprising that this should be given so much attention. The transition to the euro is a project of gigantic proportions. Someone, probably a Frenchman, has tried to indicate the size of the operation by comparing the weight of the coins to be distributed with the weight of the Eiffel Tower. The coins are supposed to weigh the equivalent of 24 Eiffel Towers! I don't know whether or not this is a good comparison, but it is certainly a huge project. Starting on 1 January next year, almost 15 billion banknotes and 50 billion coins will be put into circulation. Up until 28 February the euro banknotes and coins and the old national ones can be used parallel to one another, but with effect from 1 March the euro, and only the euro, will be legal tender throughout the euro area. The changeover is not merely a question of replacing old banknotes and coins with new ones in euro; it also involves all manner of changes from parking meters and new values on stamps to converting prices and wages.

The fact that the euro will soon make the transition from the electronic world to the more tangible world of physical notes and coins has a strong symbolic value for the political endeavour to bring the countries of Europe closer together. It will also make it easier to compare prices of goods and services across the entire spectrum throughout the euro area. It will be interesting to see how this contributes to reduced price differentials. Firms will need to consider their price-setting strategies and costs in the production and distribution chain. At the same time, it is important to emphasise that the major step in the economic integration process was taken back on 1 January 1999, when eleven countries irrevocably fixed their exchange rates and the euro began to be their currency. Despite the fact that anyone travelling between the euro countries and wishing to use banknotes and coins has had to exchange them, the national currencies have merely served as different expressions of the same thing, namely the euro, after 1 January 1999. Since that date there have been major changes in the economies of the euro countries, not least in the foreign exchange markets and the markets for securities, which, among other things, I will discuss today. In the following I shall begin by discussing the development trends we have seen on the markets for securities over the past few years and then take up various impediments to continued integration in the securities field. After this I intend to speak about the significance of the single market and the single currency for Sweden.

Capital adequacy rules steer the euro money market

Let us begin by examining the money market, where short-term securities are traded, normally loans to be repaid within a year.

The interbank market for unsecured transactions became almost fully integrated right from the start of the monetary union in 1999. The joint monetary policy and harmonisation of market practices were the main reasons for this rapid process. However, the relatively immediate success of the joint reference interest rate EONIA and the well-functioning settlement of cross-border payments via TARGET also played a large role. Since then we have seen a particularly strong increase in activity among various derivatives. According to ECB studies, this development is partly because the banks need to allocate less capital to meet the capital adequacy requirement for derivatives than for other money market instruments.

Both the repo market and the market for securities with a short duration, such as treasury bills and commercial papers, have developed relatively well, but there still remains a clear national segmentation. In the repo market this segmentation seems to primarily reflect difficulties in assessing the underlying securities, while integration on the market for short-term securities is mainly hampered by the lack of a harmonised trade environment and separate systems for settlement. The fact that the euro countries also have different tax systems is evidently another important barrier to continued market integration.

Evident success for euro corporate bonds

The bond market takes over where the money market stops. It is on this market that interest-bearing securities with a maturity of at least one year are issued and traded. Recent developments have clearly illustrated that the euro has established itself on the international bond market. Although the total stock is still significantly lower than the corresponding stock of international dollar bonds, the euro has passed the dollar in terms of new issues. This boom is due to several factors. One of these is that the euro has eliminated the exchange rate risk between the Euro countries and thereby given rise to a broad and deep source of financing. The development also reflects a dawning maturity in the euro-dominated bond market and shows that the market can function as a savings alternative when the stock market bubble has burst.

The positive development has been most obvious in the trade in euro-denominated corporate bonds. The upturn here began in 1999 and has continued ever since. It has largely concerned a relatively limited number of very large new issues within a small number of sectors. Behind a number of expensive structural deals lies the single market and general trends such as deregulation and technological developments, but the genesis of a large bond market in the domestic currency has contributed to easier financing in these forms. During the past year the large European telecom companies' need to finance their tenders for UMTS licenses has also made a contribution. Instead of using the stock markets, these companies have turned to the rapidly growing euro bonds market. However, although there is reason to be pleased with the positive development in corporate bonds, I personally believe it is too early to draw any far-reaching conclusions on the continuing strength of this market. The successes over the past year have been achieved in a situation that was very favourable for bonds, with severe falls on stock markets around the world and a large demand for other investment forms.

The expansion in the euro-denominated corporate bonds market has coincided with, and to some extent benefited from, the other major trend on the bond market, namely the declining supply of treasury bonds. This development in turn is a consequence of the consolidation of central government finances in the euro countries. However, at the same time, the introduction of the euro has led to increased competition for treasury-bond investors' money. Previously, the governments were alone in their respective domestic markets. Today, they are doing battle for loans from the same source of financing. This competition has led to a number of changes to increase liquidity on the secondary market for treasury bonds. For instance, the average size of the issues has increased. The editions have also become increasingly standardised. Other means used to maintain liquidity are repurchases and bond swaps. On the other hand, the cross-border diversification in investors' portfolios has increased at a much slower rate than anticipated.

Rapid expansion in the euro stock market

With regard to the stock markets, stock exchange trading in the euro countries was converted into euro right from the start of the EMU in 1999. This means that approximately three-quarters of share trading throughout Europe and one-quarter of international share trading is now in euro. If one examines this development a little more closely, it becomes clear that the increased degree of financing outside of the banking sector that can now be perceived on the interest rate markets is also visible in the stock market. It is possible to measure this development in slightly different ways, but all measures show the same picture. If we look at the development over the past ten years, we can see for instance that market capitalisation in relation to GDP has grown from approximately 20 per cent in 1990 to almost 90 per cent in 2000. This means that according to this measure, the euro countries have passed Japan, while the USA is still ahead of them. It is interesting to note that the EU countries outside of the euro area are at approximately the same level as the USA, or at just over 150 per cent. However, the stock markets in the euro countries are growing rapidly. Between 1995 and 2000 the value of the listed companies in the euro area grew by 276 per cent. The corresponding figure in the USA was 206 per cent. Looking at the number of new issues and number of listed companies also gives a picture of a strong development in Europe. All in all, there is a clear picture that companies in the euro zone use risk capital to a lesser degree than those in the USA, but that the differences are rapidly declining.

The rapid developments have also put greater pressure on structural changes in the infrastructure of the stock markets. Since the introduction of the euro, we have seen several examples of co-operation and mergers between stock exchanges in Europe. Euronext, the merger between the stock exchanges in Paris, Amsterdam and Brussels, is one example. But, as with the interest rate markets, there are still important barriers to a complete integration in the stock market.

Barriers to further development of the euro market

Despite the positive development in trade in securities in the euro area, developments in these markets in Europe are still in general behind developments in the USA. The difference between Europe and the USA is mainly because the USA is one country, while Europe consists of many. However, another explanation for the difference usually given is that Europe's credit markets are dominated by banks, unlike those in the USA. This is mainly because the US legislation, in the form of the Glass-Steagall Act from 1933 and various anti trust laws, has effectively prevented the banks from taking on an overly dominant role. Instead, the securities markets in the USA have played a more important role, and it is apparent that Europe is heading towards an Americanisation in this respect. But as I said, there still remain a number of barriers of varying degrees of difficulty. I will give a few brief examples, using the treasuries market.

There are 12 issuers of treasury papers in the euro area, and thereby 12 primary markets with slightly varying credit risk. The countries differ with regard to everything from legal traditions, issue procedures and counterpart systems to market infrastructure and conventions. It is easy to see that these differences mean that the secondary market for euro-denominated treasuries is not uniform. Another problem is which country's papers should form the benchmark. This is important, as the country with the benchmark issue will by definition be able to borrow at the cheapest rate . The lack of a given benchmark curve which ensues from this has led to both higher financing costs and a less efficient use of treasuries as collateral. Today it seems as though French treasuries function de facto as a benchmark for shorter-term securities , while German treasuries have the same function for longer-term securities.

Breaking down barriers is a high priority task

The market usually finds solutions to most problems. But sometimes it can be good to give it a little help. A lot has been done in the markets for euro-denominated treasury papers, but a lot still remains to be done. One example is the discussions on joint procedures and dates for issuing the euro countries' treasury papers. An increased degree of standardisation and a review of the counterpart system in the central government loan market are also welcome steps. It is perhaps even more important to establish common regulations for managing collateral and to introduce joint systems for clearing and settlement.

It is clear that there is also much to do to strengthen developments on the securities markets in general. There is a lot of work underway to achieve this at the moment. The action plan for financial services adopted by the EU countries is aimed at solving many of the legal problems, in order to give the securities markets common ground. The 40 or so legislative proposals taken up in the plan should come into force by 2005. In an attempt to hasten this process, the Lamfalussy Committee has illustrated how legislation in the financial field within the EU could be adapted more simply. The Committee also identified a number of areas in the action plan that ought to be given special priority. The Committee's proposals were approved at the EU summit meeting in Stockholm in the spring, and the first proposals for directives are now being discussed.

I would like to emphasise the importance of this work. Well-formulated, flexible legislation is necessary to enable the financial sector to provide a positive contribution to economic growth. This is made through enabling payments to be made more cheaply, risks to be distributed better and savings to be more easily channelled into profitable investments. The comparison with the USA also indicates that there is great potential to be realised in this respect in Europe. The securities market has particular importance in this context. Firstly, as we have seen, the securities markets have gained greater importance as sources of financing for companies, both with regard to risk capital and borrowed capital. Their significance for savers is growing correspondingly, which is clearly illustrated by the rapid development in households' mutual fund savings. As the markets develop they, and more specifically pricing on them, also take on greater significance with regard to resource allocation in society. In other words, improved measures are extremely important.

The role of the euro in Sweden

After this glance at what is happening on the euro markets, allow me to turn to the role of the euro in Sweden. I intend to begin with the effect on the securities markets and move on to euroisation and competition.

What has the euro meant to the Swedish securities markets so far? My view is that it has so far had relatively little effect. We should remember that developments on these markets are primarily influenced by globalisation and technological developments. And as elsewhere, this has led to frantic activity in consolidation and improving efficiency. Within EMU the introduction of the euro has clearly hastened this process, but in Sweden the euro's influence is of a more indirect nature. The euro market exists as an important alternative, and can thus be said to sharpen competition on the Swedish securities markets through its mere presence. It first and foremost fulfils a need that the krona market cannot completely satisfy. The euro market is perceived as deeper and more liquid, and thus provides an opportunity to borrow large volumes. I am thinking here of, for instance, the large Swedish corporations' need of capital to finance the major structural deals made in recent years. In order to borrow really large volumes, companies like Volvo, Vattenfall and Ericsson have largely turned to the euro market to issue bonds. From this perspective the euro has proved to be an interesting financing alternative to the other large currencies - the dollar and the yen - for large Swedish corporations. Small and medium-sized companies, on the other hand, still turn mainly to the krona market.

Development on the money market are largely the same. It is quite clearly the larger corporations that are active in euro, for instance through certificate programmes, while the smaller companies issue their certificates on the krona market. At the same time, it should be said that the total Swedish activity on the euro money market is very limited.

Swedish firms' euro activity on the stock markets is not particularly widespread, either. According to the Stockholm Stock Exchange statistics, only six Swedish companies have chosen to be listed on exchanges in the euro area. Swedish companies' interest in becoming listed abroad is mainly aimed towards London and New York. Nor have many companies taken up the Stockholm Stock Exchange's offer to list shares in euro, either exclusively or parallel, on the OM Stockholm Exchange. Three companies took up this offer in 1999; Electrolux, Nordea and Stora Enso. Since then no other companies have shown an interest. There has also been very limited trading in these shares.

It can be concluded that the role played by the euro in Sweden is a small one, even in other contexts. This is not really surprising, as the krona is the only legal means of payment that everyone is obliged to accept in Sweden. According to the price information act, goods sold to individual consumers in Sweden must be priced in the currency relevant to the customer. The act does not state which currency prices should be stated in, but as long as most wages are paid in krona, the retail trade is obliged to price goods in krona. The role of the krona as a means of payment and unit of account is thus protected.

Although there is great freedom to choose other currencies, the krona thus has a special position in the Swedish economy. There are also strong economic reasons for Swedish companies and households wanting predictability in their real income to use the krona as contract currency; this applies as long as the value of the krona is upheld, i.e. that there is a low inflation rate, as the real value of the income is determined by price developments on the goods and services consumed by the household/company. In the long term, the development in real purchasing power of the income is determined by productivity developments. Then real purchasing power parity also prevails, i.e. the price of an article is the same in the long term, regardless of the country in which it is sold and the currency in which it is priced. This means that a country with goods and services that cost a lot in foreign currency will sooner or later have to depreciate its currency and/or lower its domestic prices.

However, in the short-term and medium-term, real incomes may vary depending on the currency in which wages and prices are contracted, as wages, prices and nominal exchange rates are adapted at different rates to changes in productivity. As we know, in the short-term and medium-term, nominal exchange rates can vary considerably, and to a greater extent than is motivated by the differences in inflation rates between different countries. This means that an article can have different prices in different countries during a fairly long period of time. This can be noticed for instance, in Sweden, where price levels are still higher than in other countries in most fields, without this being fully explained by differences in VAT. While Sweden's membership of the single market has certainly led to stiffer competition and greater price pressure in some areas, competition still appears to be weak in several branches and sectors. Increased competition contributes in principle to a convergence in price levels, as the rate of price increase declines, or as prices perhaps even fall on a market exposed to greater competition. All else being equal, inflation in Sweden would then be lower than the inflation target of 2%, and this would not normally be counteracted by the Riksbank's monetary policy, as it is a temporary effect. Naturally, it is difficult for the Riksbank to decide in practice whether such price trends are a result of increased competition unless they are, for instance, connected to changes in regulations. It should also be pointed out that in practice, not all goods and services will be objects for cross-border trading and that competition will not therefore be completely all-inclusive, even when the single market has been implemented.

The actual introduction of euro banknotes and coins will not noticeably increase competitive pressure in Sweden, as prices here will continue to be expressed in krona and prices in the euro countries will be expressed in euro. This will probably continue to give some scope in the future for specific pricing adapted to Swedish conditions.

I stated earlier that the role of the krona as unit of account and means of payment in Sweden is unlikely to be affected by euro banknotes and coins becoming legal tender in the euro area as of 1 January 2002. The krona is also likely to continue to play an important role as store of value for Swedes, as least uncertainty over real growth in net wealth, i.e. future real purchasing power, will be achieved if households save and borrow in assets and liabilities in their domestic currency, as long as price stability is maintained. Hence, a large part of Swedish households' assets and liabilities are held in krona today. Those Swedes who now choose to build up their future purchasing power by buying euro bonds are probably intending to pay for their future consumption in euro, either by moving to a euro country or because they assume Sweden will adopt the single currency at some point in the future. This applies at any rate to interest-bearing assets, while for equities uncertainty over the future real value is only very slightly connected to the currency in which the share is issued. Basically, the earnings are determined by where the company has its production and sales and by the competitive situation. It is the profits that increase equity and thus shareholders' net wealth and real purchasing power.

The choice of basic currency is not self-evident for multinational companies with owners, production and sales spread throughout the world. Essentially, it should be the shareholders' country of domicile that determines the currency. When this question was discussed prior to the introduction of the euro in 1999, the focus was on the size of the portfolio effects if several large multinational companies domiciled in Sweden were to convert to regarding the euro or another currency as their domestic currency. The connection was then made to the possibility of denominating and accounting in a currency other than the krona. There were considerable difficulties in assessing the possible size in portfolio shifts, but the illustrative examples then produced showed large shifts in portfolios. It was also assumed that demand for the krona on the futures market would decline significantly, as companies would not try to counteract uncertainty in profit forecasts by hedging expected net income in foreign currency against krona. Investments of liquid funds and profits accumulated over the year in krona would also decline for the same reason. However, it was difficult to make any well-founded forecasts of the effect on the krona exchange rate, inter alia because the companies' strategy with regard to hedging of export income and equity are not strictly applied. So what has happened? It doesn't seem as though very much has happened. Companies can keep their accounts in euro now, if they wish. Some companies, mostly smaller ones, have chosen to do so. The changes with regard to investments of liquid funds that some believe they have observed are thus not based on a change in accounting currency. The fact that perceptions of the existence and degree of changes in behaviour differ may indicate that strategies differ between companies and over time.

To summarise, there are many reasons why the euro will still only have a minor effect on the role of the krona in the Swedish economy after 1 January 2002.