Mr Bergo looks at the impact of the euro on the economies of non-member states

Speech by the Deputy Governor of the Central Bank of Norway, Mr Jarle Bergo, to the Scottish Norwegian Business Forum, in Edinburgh, Scotland on 3/2/99.

At the beginning of this year we witnessed the implementation of the greatest monetary reform of the century: the launch of the euro and the final stage of EMU.

Norway watches this great experiment from the outside, but we are not uninfluenced by it. On the contrary, it constitutes an important change in the environment of our policy-making, especially with respect to monetary policy. In addition, there are important questions concerning the use of the euro by Norwegian economic agents and possible implications for the Norwegian business sector, particularly the banking and financial industry.

I shall try to address these issues. My basic proposition will be that in most respects the euro does not give rise to fundamentally new challenges, but almost certainly accentuates some that are already present.

The euro and Norwegian monetary policy

Monetary policy in Norway has been oriented towards maintaining exchange-rate stability for almost the entire post-war period. When the Bretton Woods system collapsed in the early 1970s, Norway joined the European "Snake". However, when the European Monetary System was set up in 1979 Norway chose a link to a trade-weighted basket of currencies. In spite of the objective of a fixed exchange rate, several adjustments of the international value of kroner were made in the 1970s and 1980s to compensate for the loss of cost competitiveness due to price and wage inflation.

From the mid-1980s the focus of monetary policy was increasingly shifted to the role of a stable exchange rate as a nominal anchor – against the backdrop of very high price and wage inflation and relatively high domestic interest rates following the devaluation in 1986. The EU countries' low-inflation track record was used as an argument for pegging the krone rate to the ECU in 1990.

The currency turmoil in Europe in 1992-93 prompted Norway to abandon the fixed rate against the ECU in favour of a sort of "managed float", now aiming at keeping the exchange rate "stable" against European currencies, but with no fluctuation margins. This regime is still in force.

In this context it is important to note that the small and very open Norwegian economy is highly vulnerable to fluctuations in the international economy. Furthermore, the petroleum sector is of substantial importance to our economy, and mainland industries are largely commodity-based. Whatever the choice of exchange rate or monetary policy regime may be, there will be considerable challenges associated with stabilising an economy which is that heavily exposed to cyclical fluctuations.

This has been amply illustrated by recent events. Whereas two years ago we were trying to fight off heavy appreciation pressures against the krone, we have since last summer seen quite the opposite tendency.

Last year, the krone exchange rate moved on a weaker trend, in spite of continued government budget surpluses and our still relatively healthy current account. As downward pressure on the krone grew, Norges Bank raised its key rates in seven steps last year, in line with its mandate to stabilise the krone exchange rate. In the course of five months, key rates were raised by a total of 4½ percentage points. In spite of this, the krone has been weaker than its initial range vis-à-vis European currencies since last August. In this situation, the focus of monetary policy must be to adjust fundamental factors in a way consistent with a return of the krone to its target range. Of course, monetary policy can do nothing to reverse the terms-of-trade shock brought about by the steep fall in commodity prices. However, the aim to stabilise the krone against European currencies implies that inflation over time cannot deviate from the inflation in these countries. If inflation is brought in line with inflation in the euro area, a return of the krone to its initial level becomes more likely. Thus, in the current situation Norges Bank must focus on relative inflation when setting interest rates. For the time being inflation in Norway, although fairly moderate in absolute terms at just over 2 per cent, is considerably higher than inflation in the euro area. Narrowing this differential is a prerequisite for strengthening the krone and is thus the best contribution monetary policy can offer in the current situation. There are, however, obvious limits to how tight monetary policy can be. Interest rates cannot be set so high that it results in an unnecessary severe economic recession and deflation, because that in itself would reduce the credibility of monetary policy and most likely weaken the krone.

Since August last year Norges Bank’s key rate has been 8 per cent – close to 5 percentage points higher than in the euro area. For the time being we find that our instruments are set in a manner consistent with bringing the krone back to its initial range over time.

This illustrates the challenges of stabilising the exchange rate of a small, open, oil and commodities-based economy against that of larger, more diversified economies. Though a much larger economy, the UK has also over time experienced problems with exchange rate targets, most recently the events that led sterling to leave the ERM in 1992 and orient monetary policy towards an inflation target.

The introduction of the euro from 1 January 1999 did not in itself require changes in Norwegian monetary policy. The euro could replace the ECU as the operational indicator of the external value of the krone. However, last spring Norges Bank also reviewed the merits of a change in anchor currencies.

Norges Bank found the potential benefits of changing the exchange rate target to a trade-weighted basket to be relatively marginal and fairly uncertain, and recommended that the Government refrain from modifying the Exchange Rate Regulation. In the Revised National Budget for 1998, the Government affirmed this view and decided that the Exchange Rate Regulation would continue to apply without any changes, with the euro replacing the ECU as the indicator of the krone’s value against European currencies. Thus, the consequences of the introduction of the euro for the orientation of Norwegian monetary policy might not appear particularly great at the outset. The launching of EMU nevertheless entails changes in the environment for our monetary policy, for the following reasons among others:

First, the European Central Bank formulates its monetary policy with the aim of maintaining low inflation for the euro area as a whole. Euroland will be a more closed economy than the individual member countries used to be, and thus exchange-rate changes less important. This can result in larger exchange rate fluctuations between the major countries than in the past. If so, keeping the krone stable against the euro might become more challenging.

Second, the launch of the euro will reinforce global financial integration and contribute to higher capital mobility, and the establishment of an efficient payment and settlement system in euros reduces the cost of moving capital. Increased mobility of capital, both in and out of countries, including Norway, could follow.

As I indicated earlier, we, like others, have experienced increasing difficulty in maintaining a stable exchange rate in a world of large, unrestricted capital flows. The relative calm within the euro area during the recent turmoil linked to the financial crises in Asia and Russia and later Brazil could be indicative of future differences between Europe’s “ins” and “outs”. Finland, despite its dependence on raw materials and relatively large exports to Russia, was less adversely affected than the other Nordic countries. For Norway, success in maintaining a stable exchange rate could become more challenging in the new environment.

Use of the euro in Norway. Euro and the Norwegian banking industry

Use of the euro in Norway

I would now like to comment on how, and to what extent, Norwegian economic agents might be expected to use the euro in the future. There are many indications that the euro will be used more extensively in trade between Norway and euro countries than the currencies of the 11 member states combined today. Over time the euro will most likely be used on an even wider scale. Obviously, the euro would increase in importance in the Norwegian market should Sweden, Denmark and the UK join EMU.

The euro may also play a role – though probably limited – as a settlement currency between residents. This will primarily be of relevance for import and export enterprises as well as sub-contractors in industries that are heavily exposed to the euro area. However, several factors point to the continued use of Norwegian kroner among enterprises and households. Government payments such as pensions, social security and taxes will continue to be in Norwegian kroner, as, most probably, will wages. Furthermore, Norwegian residents are not permitted to settle outstanding claims in foreign currency in cash, according to Norwegian Foreign Exchange Regulations.

Regulatory issues

Norway is under no obligation to incorporate EU legislation pertaining to the introduction of the euro into Norwegian law. However, there has been some discussion as to whether it would be appropriate to implement some changes in the regulatory framework.

One issue has been whether there is a need for statutory amendments to assure the continuity of contracts in which the parties' payment obligations are expressed in ECUs or in one of the participating countries' currencies. Norwegian law is considered to be clear on this issue, however, and in the view of the Ministry of Finance there was no need for legislative changes. In its deliberations on the Revised National Budget last spring, the Storting (Norwegian parliament) took note of this.

Another issue is the possibility of keeping accounts in currencies other than the Norwegian krone. The new Accounting Act, which entered into force on 1 January 1999, provides for the registration of accounting information in Swedish, Danish, English or Norwegian. Annual company accounts, however, are to be recorded in Norwegian kroner and in the Norwegian language unless otherwise provided for by regulation or separate decisions by the Ministry of Finance. The annual report must be written in Norwegian. Under certain circumstances, consolidated accounts may be recorded in a foreign currency. Accounts expressed in a foreign currency may also be published as a supplement to accounts in Norwegian kroner.

A third question was whether it should be possible to quote financial instruments traded on the Oslo Stock Exchange in euros and, if so, whether this would require changes in stock exchange legislation. A broadly based committee appointed by the Oslo Stock Exchange has addressed this question. The committee concluded that, although this situation may change, there is little interest in the Norwegian securities market in quotations and settlements in euros. The committee found no legal obstacles to quotations and settlements in euros. Consequently, the Ministry of Finance has not found a basis for recommending changes to stock exchange rules. The Ministry of Finance has also considered whether conversion to euros should be regarded as realisation within the interpretation of tax legislation. The Ministry has concluded that the parties' positions are not actually altered by conversion. The Ministry therefore maintains that assets and liabilities recorded in the currency of an EMU country cannot be considered as realised after that currency was replaced by the euro.

Euro payment systems

A common monetary policy in the euro area is contingent on cross-border payments in euros taking place just as rapidly and efficiently as payments in national systems do today. All countries participating in EMU are therefore linked to a common payment system, TARGET. In addition to being a channel for monetary policy, TARGET is, however, designed to enhance the efficiency and reliability of cross-border payment systems. TARGET is therefore used for settling both monetary policy and commercial transactions. EU countries outside the euro area are also linked to the system.

Payment settlements using TARGET take place on a real-time gross basis. This means that transactions are settled individually and with finality throughout the day. The system is also used to settle net positions generated through netting of gross positions between banks.

The TARGET system consists of the national settlement systems linked together into a communications network called Interlink. Payments are transferred from one country to another via the settlement system of the payer country, where the central bank debits the payer bank’s account and credits an account of the central bank of the beneficiary country. In turn, the central bank of the beneficiary country credits the recipient bank.

There are several alternative systems for making cross-border payments in euros. The most important are probably the Euro Banking Association (EBA) clearing system and the traditional network of correspondent banks. In addition, some large domestic clearing systems like Euro Access Frankfurt (EAF) allow banks from all EU countries to participate. The participants naturally take such factors as price, risk and time into account when considering whether to make use of TARGET or any of the other options.

The Norwegian banking industry has expressed an interest in having Norges Bank provide settlement services for a multilateral netting system for domestic transactions in euros. As an EEA member, Norway participates fully in the single market (with the exception of agricultural products) and Norwegian banks are subject to the same requirements and obligations as those applying in the EU. Access to the common payment system on virtually equal terms is therefore regarded as desirable and natural. Norwegian banks attach importance to being able to offer competitive euro services, and a Norwegian euro settlement system could make a contribution in this respect. Norges Bank is pursuing this matter with the ECB. We have taken note of the solutions found with respect to the non-euro EU members, including the UK.

Developments in the Norwegian banking industry

The industry that will probably be most affected by the euro is the banking industry. The banking industry in Norway and other countries has undergone, and will continue to experience, substantial changes as a result of technological advances, internationalisation, deregulation and changes in customer behaviour. This has intensified competition and reduced margins, thereby prompting a need for restructuring and reducing overcapacity. In addition to increased competition between banks, new participants – both financial and non-financial – have contributed to increasing the pressure on margins. Securities markets have also become more important in terms of their role in saving, financing and risk management, adding to the pressure on financial intermediaries such as banks.

Like banks in other countries, Norwegian banks have had problems compensating for the decline in net interest income by increasing other income or reducing costs. Intensified competition both between banks and from other financial market participants suggests that banks will in general be facing major challenges in the years to come. On top of this comes EMU, which will probably amplify some of these trends.

The euro will have varying effects on different market segments. The most immediate consequence of the transition to the euro is the elimination of foreign exchange and hedging transactions in the currencies concerned. As exchange between euro-country currencies accounts for a very limited share of total currency exchange in Norwegian banks, this will be of little consequence.

Two other areas that will be directly affected are international payment transactions and liquidity management. International payment transactions do not represent a substantial source of income for Norwegian banks. However, it will be important for banks to be able to provide competitive payment services in euros to avoid losing customers.

Foreign lenders today account for close to 30 per cent of all loans to Norwegian enterprises, a share that has been stable for the past five years. Thus far, foreign branches in Norway have primarily focused on the largest enterprises and financial market segments that demand more advanced services. As the euro gradually gains a foothold in the Norwegian business sector, the Norwegian market may prove to be of greater interest to foreign banks. Nor can we disregard the possibility that mergers and acquisitions in the Norwegian business sector – which may partly be perceived as a response to consolidation in the business sector in the euro area – will lead to a situation whereby a larger number of Norwegian enterprises move into the “division” where foreign competition is strongest. Norwegian enterprises with close ties to the euro area will also demand a wide range of euro services from their banks. For this reason, foreign banks will probably compete more intensely with Norwegian banks in the future. Technological advances, including the development of new channels of distribution, will reinforce this tendency.

Substantial overcapacity in the financial sector in European countries, particularly in traditional banking, has spurred the need for enhancing efficiency and consolidation. Over the last couple of years we have seen a considerable increase in the number of mergers and acquisitions in Europe, with mergers taking place both within and across national borders. The introduction of a single European currency has probably been an important catalyst in this process. Mergers and acquisitions create entities with ambitions, financial strength and, not least, a range of services well designed to compete on international markets. This points to increasing competition across national borders.

Several large Nordic bank conglomerates define the Nordic area as their home market, and have established, or plan to establish, branches in most Nordic countries. The largest Swedish and Danish banks have been the most active so far. A few of them, in contrast to other international banks established in Norway, have started to show an interest in the market for households and small and medium-sized enterprises. The strengthening of the position of Nordic banks in their home market may partly be perceived as a defensive strategy to keep out large global banks. The launching of a single currency in Europe may have been an important driving force.

The euro is likely, at least in the short term, to be of greater consequence to the banking sector in euro countries than in Norway and other countries outside the euro area. The loss of income in some areas, such as currency trading, is greater for banks in the euro area, and the costs associated with adapting systems, etc. are also higher. In addition, cross-border competition is likely to intensify more between countries with a single currency than between euro countries and non-euro countries, although this is not certain. These factors point to a reduction in earnings for euro area banks. However, increased competition may in the longer term enhance the efficiency and competitiveness of banks.

The introduction of the euro will also have a considerable influence on the development of securities markets in euro countries. There is reason to believe that capital intermediation via the securities market will increase at the expense of financial institutions. The elimination of foreign exchange risk, greater price transparency and harmonisation of market practices will increase liquidity in the market, leading to conditions similar to those in the US.

Losing the advantage of operating in the national currency will result in keener competition in securities markets for brokers, issuers, investors and stock exchanges. National ties will be of less importance as participants are drawn towards markets with the lowest costs. The integration of stock exchanges will increase. The Oslo Stock Exchange, for example, is one of several stock exchanges currently evaluating prospective partners.

The possibility that the euro may lay the foundation for a European market for private bonds should be of interest to enterprises both within and outside the euro area. This market is large and well developed in the US, whereas European enterprises have primarily relied on bank financing. The introduction of the euro will also result in a broader and more differentiated selection of securities in a single currency, while increased competition in issue and investment services will probably make it less expensive to raise capital directly in the securities market. The elimination of currency risk in the euro area will also enable investors to focus more on credit risk, thereby improving their ability to evaluate this risk. This may make the market more receptive to private bonds, as investors may be willing to accept higher credit risk when seeking a return. This factor, combined with lower borrowing costs, may give medium-sized enterprises, which so far have had to rely on bank financing, increased access to the bond market.

It should be emphasised that the expected increase in competition in securities markets in the euro area is not solely due to the single currency. Technological advances, deregulation and harmonisation of laws and regulations are important forces contributing to a freer flow of capital and services in the single market. There is little doubt, however, that the introduction of a single currency will make a major contribution to accelerating this process.

In sum, trends influencing developments in the banking and financial industry such as deregulation, internationalisation, changes in customer behaviour and rapid technological advances – leading to intensified competition – have been there for some time and will continue. However, the establishment of monetary union will probably intensify existing trends, creating even greater challenges with regard to competition in the banking and financial industry.

This brings me back to the basic proposition made in the introduction. In many respects, the euro will not give rise to fundamentally new challenges. It is highly likely, however, that the euro will accentuate challenges that are already present. And that, I think, goes for the UK as well as Norway.

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