

Preparations for EMU and the question of ERM

*Address by Mr. Urban Bäckström, Governor of Sveriges Riksbank,
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Introduction

This weekend the finance ministers and central bank governors of the EU's member states will be gathering in Dublin for an 'informal' Ecofin meeting. While this type of six-monthly assembly does not make any formal decisions, it does represent continued progress in the preparations for the establishment of a European Monetary Union on 1st January 1999.

Expressed in EU-speak, the Dublin agenda includes the stability pact and the issue of Ins and Outs. The first item concerns ways of maintaining fiscal discipline in the member states after the completion of EMU and the second is about the coordination of the monetary and exchange rate policy of the countries participating in the EMU with the policies of the non-participants.

In Sweden a discussion is under way about Sweden's future relationship to EMU. The question is whether Sweden will strive to belong to the first group of countries that form the EMU or whether the political process leads us to wait and see. The Riksdag (Sweden's parliament) is to adopt a position on this matter in the autumn of 1997. In the meantime the Riksbank is

taking an active part in the preparations that have to be made so that the Riksdag in practice is free to choose either way.

Sweden and EMU

The idea of closer economic and monetary cooperation between the member states of the European Union is far from new. Increased monetary cooperation has been identified as one of the prerequisites for continued European integration ever since European cooperation began in the 1950s. Even the Treaty of Rome, from 1957, mentions the co-ordination of monetary policies, albeit in terms that are rather vague, which is a reflection, not least, of the economic stability at that time.

The situation changed in the late 1960s. Shifts in exchange rate parities in Europe led to the drafting of the Werner Plan, initiated by France and Germany. Presented in 1970, the Plan contained proposals for the introduction of an economic and monetary union in three stages. The Plan was adopted unanimously by the Ecofin Council in March 1971 but it came to nothing in the turbulence that resulted from the subsequent collapse of the Bretton-Woods system and the oil crises. However, one of its ideas lived on in the shape of the European currency snake, which can be seen as the forerunner of the present ERM. The ideas about closer cooperation were revived in the late 1980s, when the principles that now underlie EMU and the Maastricht Treaty were drawn up by the Delors Committee.

Sweden has a history of participation in and inspiration from various international arrangements in the field of monetary policy. Examples are the gold standard, the Scandinavian currency union and the Bretton-Woods system. The Swedish krona was linked to gold, directly or indirectly, for almost a century and for longer than that the rate of inflation averaged what today would be called a 'good European level'. Many of us are conditioned by the 1970s and '80s but those decades constitute the longest period of inflation in modern times and are actually a departure from our tradition. From 1870 to the early 1970s economic growth in Sweden was among the highest in the world. It follows that low

inflation and economic stability did not prevent high, sustained growth and employment. On the contrary, low inflation would seem to be one of a number of important conditions for rising prosperity.

The EMU is the new project in the 1990s for international monetary policy cooperation in our part of the world. It poses risks and difficulties but also offers appreciable advantages and opportunities. The discussion in Sweden seems to be rather preoccupied with the difficulties at the expense of the possibilities. In a way this is surprising, considering that the project is so clearly in line with our country's monetary policy tradition.

The Swedish discussion about EMU should focus less on whether or not a full monetary union should be established in Europe and concentrate more on an appraisal of Sweden's participation in the event that - as now seems most probable - many European countries move to a single currency in Stage Three. It is important that in this debate we also weigh up, clearly and explicitly, the costs of remaining outside.

For its part, the Governing Board of the Riksbank has come to the conclusion that 'Sweden's adherence to a European monetary union has overriding advantages'.

The preparations for EMU

The timetable is becoming tight but the preparations by the various EU institutions are continuing according to plan. As early as in the spring of 1998 the heads of state or of government of the EU countries are to decide which member states participate from the start. Shortly thereafter the European Central Bank is to be established. EMU begins on 1st January 1999; exchange rates are fixed and monetary policy is taken over by the European Central Bank. Euro banknotes and coins are to be in circulation by 1st January 2002 at the latest.

In order to coordinate the preparations in the domain of central banks, the European Monetary Institute (EMI), located in Frankfurt and the forerunner of the coming central bank, is instituting a large number of projects in various areas. The latest

list contains 89 concurrent projects for the run up to EMU. Other projects have been completed and there will no doubt be some future additions. The discussion of many matters must be completed and decisions reached before the end of this year; other issues can continue to wait. The areas in question are the construction of monetary policy, the coordination of payment systems, the design of banknotes, the collection of statistics, etc.

The Riksbank and its staff are participating in everything from groups of experts and subcommittees to the committee of alternates and the EMI Council. The Riksbank has also initiated work on practical preparations in Sweden. A general advisory group for the financial sector, headed by the Riksbank, has been set up and includes senior representatives of government institutions. In this group joint consultations about the move to a single currency are arranged with the Swedish Bankers' Association and various groups of financial institutions outside this Association, insurance companies, securities institutions and institutions for clearance and settlement. The advisory group organises and monitors the work of a number of subordinate working groups.

Sweden's economy and convergence

In recent years the imbalances in Sweden's economy have been reduced and the conditions for stability have improved. Since the upturn around mid 1993, growth in annual terms has averaged 2.5 per cent. The surplus on current account is comparatively large. The financial crisis has been mastered. Moreover, the general government deficit is diminishing successively, with most of the evidence pointing to a level of not more than 3 per cent in 1997 and balance in 1998. Inflation is now also low and inflation expectations have moved down. This has been accompanied by a reassessment of Swedish economic policy in financial markets; the exchange rate has strengthened and bond rates have fallen.

There has thus been a marked improvement but the situation is not bright in every respect. Unemployment and government debt are high, though the latter is expected to fall

relative to GDP, and wage setting has not yet adapted to a world of low inflation. But on the whole, improvements have occurred in several parts of the Swedish economy and the picture has accordingly changed appreciably. Sweden also has a good possibility of meeting the criteria for participation in EMU right from the start.

Today it seems that economic activity and demand in Sweden are beginning to recover after the slowdown that began towards the end of last year. In the first half of 1996 investment and foreign trade both made comparatively large contributions to growth. Some increase in private consumption was countered by a corresponding fall in public consumption. Enhanced confidence in economy policy, evidenced for example by lower inflation expectations, has led to a stronger exchange rate and decreased interest rates, which provides for more balanced growth in the years ahead. Altogether, this amounts to good prospects of inflation being in line with the inflation target in the coming years.

'Ins and Outs' and the exchange rate criterion

The issue of Ins and Outs concerns the relationship between countries that participate in EMU from the start and those that for various reasons remain outside. After last spring's informal Ecofin meeting in Verona, a report was prepared from the Ecofin Council to the meeting of heads of state or of government in Florence. The report outlines some basic features of a new exchange rate mechanism:

- The euro to be the anchor
- Central rates to be set in a common procedure involving finance ministers, the European Central Bank (ECB) and national central banks
- The central rates to be monitored, with the possibility of the parties concerned, including the ECB, initiating realignments if necessary.
- Intervention to be obligatory when a margin is reached but the ECB as well as central banks in outside countries would be

entitled to discontinue support if this threatened their own price stability

- Broad bands should be the standard model but the development of stricter links and cooperation is to be possible on a discretionary basis

After the Florence meeting there have been further deliberations on the new exchange rate mechanism. The discussion this weekend will start from the basic features outlined above. It is envisaged that the Ecofin Council will subsequently report to the December meeting of the European Council in Dublin, when a political agreement is to be concluded on the system for ensuring exchange rate stability between Ins and Outs.

Sweden has consistently stressed that convergence of economic fundamentals is a basic prerequisite for exchange rate stability. Participation in an exchange rate mechanism is not a substitute for this. Each EU country should be free to choose the way in which monetary stability is achieved. An inflation target such as Sweden's stands for an ambition to align economic policy for stability that is just as great as that of a country with a fixed exchange rate target.

Sweden has also gained a hearing for the view that participation in the exchange rate mechanism is to be voluntary. In order to give more credence to the argument that alternative arrangements would be able to generate the same economic stability, we have underscored the importance of monetary and fiscal policies being effectively monitored by the ECB and the Ecofin Council.

Another, related issue concerns the exchange rate criterion. In this respect the Treaty provisions are interpreted differently. A majority of countries, with a central role in the work of constructing the monetary union, consider that participation in the ERM is to be mandatory for two years prior to participation in EMU. Other countries, of which Sweden is one, have argued that exchange rate stability as such is decisive, not participation by itself.

The exchange rate criterion will no doubt continue to be discussed but the final answer to the question of its interpretation will have to await the treatment of this issue by the European

Council in the spring of 1998. Until then, therefore, Sweden's interpretation holds good.

Sweden and the ERM

Notwithstanding the Swedish position on the exchange rate criterion, the conditions for Sweden's adherence to the ERM should be analysed and discussed. A decision whereby Sweden joins the ERM must rest on support in the Swedish community. An open discussion about ERM participation as such, as well as about the forms for this, is therefore important.

Sweden's adherence to the ERM could be seen as a general confirmation of the improvement that has been achieved in conditions for stability and also as a further manifestation of our determination to conduct economic policy with a view to sustained stability. Demonstrating this firm determination is important for a coming participation in EMU and perhaps even more important if Sweden were to choose to defer participation. It is ultimately the long-term credibility of this ambition that leads to market rates of interest at a sustainable good European level. ERM could provide support in this respect and also give the Riksdag (Sweden's parliament) greater freedom in arriving at a decision in the autumn of 1997, be it to join EMU from the start or to wait.

The Riksbank has emphasised earlier that inflation expectations have been so high and the economic imbalances so great that adherence to the ERM would hardly be perceived as credible. The lesson Sweden has learned from the exchange rate turbulence in the autumn of 1992 is that the road to a stable currency entails conducting a credible economic policy for stability and not just issuing declarations about a fixed exchange rate.

In recent years, as I mentioned earlier, the imbalances have been reduced and the conditions for economic stability have improved, though the adjustments are not yet complete. Continued progress in the right direction makes it possible to consider adherence to the ERM, though it is still not clear whether this would be economically appropriate.

To date, our experience of the flexible exchange rate regime and the inflation target has been good. Economic policy has focused on achieving domestic monetary stability. A good performance in this respect is mirrored in a stable exchange rate. This is the reverse of a situation where the exchange rate is targeted with the aim of achieving the same rate of inflation as in the countries with whose currencies the krona is linked. But the ultimate objective - inflation around 2 per cent - is the same.

We should work our way towards a perception that an inflation target can be combined with ERM participation. From this point of view, deviations from the fixed central exchange rate that display more permanent tendencies and also threaten to affect inflation would be countered with interest rate adjustments, upwards or downwards as the case may be. This would be done, not to defend a particular level of the exchange rate but to ensure that Sweden's inflation target is met. This target corresponds to the good European level that applies in the ERM countries.

Such an arrangement is not all that different from the way things work today. The development of the exchange rate is one important indicator of the degree of confidence in economic policy and of the inflationary pressure in a small, open economy.

Low inflation and good confidence in economic policy render the exchange rate stable and it should also be possible to generate this stability in the context of ERM participation with the aid of Sweden's inflation target.

An issue worth discussing is whether a conflict may arise between the inflation target and participation in the ERM. Considering the present parameters for ERM participation, the risk of this should be slight as long as confidence in economic policy continues to improve. But the inflation target should be, as at present, the paramount objective of monetary policy. That would also be consistent with the EU's monetary policy guidelines, as well as with the prevailing principles behind the discussion of Ins and Outs.

I want to make it clear that at present ERM participation is not an immediate issue. At the same time, a thorough discussion of this matter is both appropriate and desirable, particularly now

that the economic imbalances have been reduced and the conditions for stability have improved.

Conclusion

It is not all that bold a guess that this weekend's meeting of EU finance ministers and central bank governors will result in further steps along the road to a European Monetary Union.

The nearer the process gets to the moment of truth, the more intense will the preparations become, as will the discussion of the project's various details. To date the work on preparations appears to be proceeding according to plan and most signs point to EMU being established on 1st January 1999. The countries that participate from the start may be a smallish group but it is conceivable that the group will be larger.

All this means that the discussion in Sweden should concentrate less on the project as such and focus instead on how Sweden should relate to a situation where many countries in Europe participate in EMU. What risks and opportunities are involved in taking part and in remaining outside, respectively? Personally I find it hard to envisage Sweden ultimately remaining outside if a monetary union is established in Europe by a majority of countries.