CURRENCY ARRANGEMENTS BETWEEN EMU AND ITS NEIGHBOURS

Remarks by Mr. Urban Bäckström,
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Let me start by thanking you for this invitation enabling me to elaborate somewhat on the relationship between the 'Ins' and the 'Outs'.

Under Article 109m of the Treaty there is an obligation to treat exchange rate policy as a matter of common interest. I assume that one reason behind this provision is the creation of a single market with freedom of movement for goods, individuals, services and capital. In order to ensure the efficient functioning and development of the Single Market, it is important that real exchange rate misalignments between EU-currencies be avoided, as well as excessive nominal exchange rate fluctuations, which could disrupt trade flows among Member States.

Sound fundamentals a prerequisite

A prerequisite for sustained exchange rate stability is the lasting convergence of economic fundamentals, in particular price stability. Sound fiscal and structural policies in Member States are equally essential. This means that in the absence of a convergence of fundamentals, any attempt to co-ordinate exchange rate policies is bound to be unsuccessful. Exchange rate policy co-operation cannot be a substitute for stability-oriented domestic policies.

Thus, it is primarily a close co-ordination of stability-oriented domestic policies between Member States that will lead to the desired exchange rate stability. Consequently, it can be argued that membership in an exchange rate arrangement is not necessary. On the other hand, one can also take the view that if the co-ordination of domestic policies is successful and delivers exchange rate stability, then Member States might as well belong to an exchange rate arrangement.

However, there is a line of reasoning that suggests that market-induced exchange rate misalignments can occur even in the absence of policy related misalignments. It has been argued that fixed parities may invite currency speculation, which could be self-fullfilling. It would then be necessary to avoid offering one-way bets by having bands that are wide enough to minimize such a risk.

This has in fact been fully acknowledged - hence the existence of the wide standard fluctuation bands in the present ERM system and their proposed continuation in the new ERM2 system. The size of the standard fluctuation band in the ERM2 has still to be decided but, as I see it, the principles of continuity and equal treatment among all Member States are important arguments for maintaining the current 15 per cent.

Why a need for an exchange rate system?

This still leaves a fundamental question unaswered. If it is the close co-ordination of stability-oriented domestic policies between euro-area and non-euro-area Member States that leads to the desired exchange rate stability, why do we need a *formal* exchange rate system? This question may well be put to the other members of today's panel, but permit me to suggest three possible answers:

- *Firstly*, the ERM has, in fact, worked quite well after 1993 and has served as an external anchor for economic policies in many Member States. Such a mechanism has helped to ensure that policies are oriented towards stability.

- *Secondly*, common agreement about a central rate could help to enhance the credibility of sound, stability-oriented domestic policies by establishing a focal point for agents' expectations.

- *Thirdly*, the present ERM and the ERM2 both contain a common agreement about a central rate. This means that an ex ante joint decision exists concerning a reference rate for the conduct of domestic economic policies in Member States. Thus, this procedure gives content to the agreement that exchange rate policy shall be treated “as a matter of common interest“.

Stability and/or formality?

Thus far I have concentrated on exchange rate stability's true foundations and on the reasons for having a formal exchange rate system such as the present ERM and a new ERM2-system. This leaves the issue of why certain countries consider the ERM membership to be compulsory prior to participation in the EMU.

My starting point here is that, already at the Florence meeting, the Heads of State or of Government declared that participation in ERM2 is voluntary. There are, of course, no legal grounds for deciding otherwise. Moreover, considering that certain Member States are not participating at present, it represents a continuation of the existing order.

Why, then, do certain countries consider the ERM membership to be compulsory prior to participation in the EMU? After all, the confirmation procedure in the spring of 1998 affords an opportunity to decide whether the exchange rate has been stable at a level that is acceptable to other Member States in accordance with the criteria for the establishment of a central rate in the ERM.

Assume a country where all the relevant indicators signal sustainable economic stability and convergence, accompanied by an exchange rate that has been definitely stable at a level that conforms with the criteria for the establishment of a central rate in the ERM, but the currency has not been a formal participant in the ERM system. What rational ground could there then be for refusing membership in the EMU, considering that the currency is shortly to be abolished and absorbed in a monetary union? In the case of a country that is preparing to join the monetary union, the reason can hardly be that the development of the exchange rate outside the ERM might constitute a threat to the stability of that union.

This leaves the argument that participation in the ERM is cited in the Maastricht Treaty. However, the exchange rate criterion is not entirely clear. Furthermore, since the Treaty was adopted the ERM has been modified. It seems unreasonable that a currency which has been a member of the ERM but has fluctuated by up to ±15 per cent should be regarded as a stable currency. Surely it is exchange rate stability as such which matters, not the institutional arrangement.

I am aware that on this point there is a broad majority of Member States whose opinion differs from Sweden's. But I still have difficulty in understanding the grounds for that interpretation. The last word rests with the Heads of State or of Government at their meeting in the spring of 1998.

I want to make one point perfectly clear. The Swedish position does not imply that exchange rate stability lacks importance for entry to the monetary union. On the contrary, we share the opinion of all Member States as regards the importance of such stability. The difference is thus one of form rather than substance. The Swedish position is rooted in the doubts that many in my country have about exchange rate arrangements, not least in the light of our experience in the early 1990s.

Sweden's central bank, the Riksbank, has during this autumn, however, initiated a discussion about swedish participation in the ERM in the context of the vigorous consolidation of government finance and the low level of inflation, together with the resultant improvement in the economic policy's credibility. At the same time we have made it perfectly clear that ERM membership is not being considered at present and will require broad support in swedish society. To date, however, the reactions have been hesitant.

To conclude, in the light of these remarks, my opinion is that monetary and exchange rate policy co-operation within the European Union should be sufficiently flexible to accommodate different strategies for economic convergence.