THE SWEDISH ECONOMY
ON ITS WAY TOWARDS
EUROPEAN MONETARY UNION

Address by Mr. Lars Heikensten,
Deputy Governor, Sveriges Riksbank,
at Unibank's Investment Seminar,
Copenhagen, May 8-10, 1996

1. Introduction

I should like to begin by expressing my thanks for the invitation to talk today about Sweden's path towards European Monetary Union.

My talk is arranged as follows:

- First I shall discuss the crisis which the Swedish economy endured in the early 1990s. In my view, the crisis was partly a consequence of economic policy's realignment. This realignment was necessary in order to achieve greater stability, with better conditions for long-term growth. It also represented an adjustment to the policy which had been conducted in much of Europe in the 1980s.

- Then I shall review what has happened in the Swedish economy in recent years and say something about the future. Higher growth, in conjunction with extensive budgetary measures and a consistently tight monetary policy, has created a foundation for a more stable or, if you like, a more Continental development.

- Finally I intend to say something about our view of European monetary integration.

2. The crisis in the early 1990s and its background

The Swedish economy went through a profound crisis in the early 1990s. In the three years from 1990 to 1992, output fell about 5 per cent. This recession was the longest and deepest in Sweden since the early 1930s and one of the worst in post-war Western Europe.

A look at earlier decades will help to clarify the recession's causes. Growth in the Swedish economy had been high and stable in the 1950s and '60s. At that time inflation and unemployment were both low; government finance was in balance and so were external payments. In the next two decades, however, the picture was very different. Opinions differ about the reasons for this but it is clear that they included both political and economic factors. Without claiming to present a full account or to know all the answers, I should like to mention some of the main causes.

- *Exchange rate policy* failed. When the Bretton Woods system of fixed exchange rates collapsed, it proved difficult to establish an alternative arrangement that gave the same stability. This meant that no firm benchmark existed for either economic policy or wage formation. A series of devaluation cycles led to widespread uncertainty, with repercussions on such factors as investment and productivity.

- An important cause of the recurrent devaluations lay in problems with *wage formation*. Productivity growth slowed without a corresponding retardation in the rate of wage increases. Instead, nominal wage increases actually tended to accelerate as employees in different parts of the economy competed for the smaller wage share. This was accompanied by further additions to labour costs in the form of increased social charges.

- *Fiscal policy* was weak, for both economic and political reasons (e.g. a more fragile parliamentary base for the Government). When economic activity turned downwards, it proved impossible to reinforce the budget to match rising expenditure and diminishing revenue. Government debt rose higher and higher.

- *Structural problems* were also at work in the economy:
a) With the rapid expansion of the public sector, the distortionary economic effects of taxes and public spending grew.
b) Certain sectors, such as agriculture and housing, were heavily regulated. In both these cases there was also a large element of subsidies.
c) Competition was also inadequate in other parts of the economy, for instance in parts of trade in goods and, at least until the mid '80s, in the financial sector.

- The imbalances were accentuated when the *financial sector* was deregulated in the mid '80s. Households and firms both accumulated debts on a dramatic scale. Being confined by the fixed exchange rate, monetary policy was not in a position to curb this tendency.

All this meant that Sweden's standing in the international prosperity league slipped. Thanks to the expansion of public activities, unemployment was held back. But by the end of the 1980s, the scope for continuing the fiscal financing of employment was very limited. At the same time, inflation had accelerated. The need for a policy realignment was evident. The devaluation policy had come to a dead-end.

3. The policy realignment 1990-91

Early in 1990 the Government of the day signalled a change of course in economic policy. Priority would now be accorded to price stability, with a view to establishing more stable conditions for growth. Work would also be stepped up on improving the Swedish economy's structure.

An awareness that policy should take this course had gradually emerged in Swedish society and the changes were also broadly supported by Swedish economists. Developments in Europe had also contributed to the new picture. Inflation there had been pressed down in the course of the 1980s and after a difficult period in the '70s, some countries - of which Denmark, the host country for this conference, is one - had succeeded in generating a stable economic development. In this situation, when Sweden applied for membership of the European Union, it was even more natural to opt for a more long-term, "European" economic policy. As confirmation of the endeavour to achieve price stability, in June 1991 the Swedish krona was tied to a basket of European currencies.

In the following years, however, economic development in Sweden changed dramatically. Industrial production faltered first, due to a combination of weaker export demand and an excessively high level of costs. Investment followed the downward path and unemployment started to rise.

The downturn then spread to private consumption. After some years with a massive increase in borrowing, household balance sheets needed adjusting. This tendency was reinforced both by a far-reaching tax reform, which included decreased tax deductions for interest expenditure, and by a rising real interest rate. The household saving ratio moved up from -5 per cent in 1989 to +8 per cent in 1992.

The high real rate of interest had to do with inflation's retardation from 10.4 per cent in 1990 to 2.6 per cent in 1992. Partly as a result of the problems with government finance, there was no equivalent change in nominal interest rates. The problem was exacerbated by the upward movement in European interest rates in the wake of German reunion. In order to defend the exchange rate, the instrumental rates in Sweden had to be raised a number of times. Matters became even worse when the winds of European currency unrest turned into a gale and a financial crisis erupted.

The need for measures to counter the weakening of government finance became increasingly acute. Cuts were implemented, for instance in local government financing and in housing subsidies. Household income was also affected, via decreased transfers and higher taxes.

Having begun as a problem of industrial costs, of the kind that Sweden had already experienced several times, the crisis accordingly became more and more widespread and ultimately involved the entire economy. Every source of growth - in manufacturing, in industries geared to private consumption, in the housing sector and in public activities - was closed.

As a result, open unemployment increased from 1.5 per cent in 1989 to 8.2 per cent in 1993. Meanwhile, government finance deteriorated sharply, from a balanced situation in 1989 to a budget deficit in 1993 that was equivalent to -12.3 per cent of GDP.

It is quite clear that at the beginning of this decade there was a great need of structural changes in the Swedish economy. Neither could the inflationary bubble that had developed in the late 1980s continue indefinitely. So a policy realignment was inevitable. To a considerable extent, however, the recession was more marked than anyone foresaw because the economic imbalances had been allowed to accumulate over such a long period and the realignment happened to coincide with a weak situation internationally.

4. The recovery begins

On 19 November 1992 the Riksbank was obliged to abandon its defence of the krona and for the first time since 1933 Sweden adopted a flexible exchange rate regime. This was done, however, only after a long autumn during which the Riksbank had raised the instrumental rate, on one occasion to as much as 500 per cent.

The defence of the krona was undermined by the tradition of devaluations and the rapidly growing budget deficit. These factors were compounded by the difficulty of using high interest rates to defend an exchange rate in an economy that was already weak, with problems in the financial system.

The krona depreciated sharply and reached a low in December 1993 that was about 23 per cent below its level when the fixed rate was abandoned. This was accompanied both by a favourable development of wage costs compared with other countries and by good productivity growth. As a result, from 1992 to 1994 relative labour costs improved by about 32 per cent.

This represented a strong stimulus to exports, particularly as international activity was now recovering. In the three years 1993-95 export growth in volume terms amounted to 7.6, 14.1 and 11.4 per cent. In this period industrial production grew by a total of 22 per cent, which meant that at the end of 1995 its level was about 15 per cent above the previous peak in 1990. Industrial investment also shot up, rising in 1994 and 1995 by as much as 29 and 38 per cent, respectively.

In the domestic market, however, growth remained subdued. The development of household income was weak, partly due to the high unemployment and sizeable fiscal withdrawals to reinforce the government budget, particularly from 1995 onwards. Households were notably concerned about their own as well as the national economy. Another factor was the high real interest rate, which also tended to accentuate the fall in residential construction.

The Swedish economy was thus in a manifestly dual situation but this had advantages as well as drawbacks. The former included the initiation of a necessary structural adjustment. From 1991 to 1995 the GDP share for manufacturing, for instance, rose from 18 to 22 per cent and in recent years the public sector's share has diminished. Moreover, the current account has begun to show substantial surpluses.

One drawback, on the other hand, is that the increased production has generated just a marginal fall in unemployment; neither is there much likelihood of an appreciable change in this respect as long as domestic demand remains weak. At the same time, the development of government finance was alarming, with an accumulation of debt in 1993 and 1994 that was the highest in the OECD area. The large budget deficits in these two years had to do with a combination of low tax revenue on account of the recession and high spending, e.g. on measures of labour market policy and the bank support.

On a couple of occasions, above all in the spring of 1994, it seemed that the Swedish economy was entering a vicious circle, where declining confidence in economic policy would lead to higher bond rates and thereby to a further worsening of the budget problems. On these occasions, moreover, the exchange rate weakened, which accentuated the inflationary tendencies.

During the spring and summer of 1994 signs of capacity restrictions in export production began to show up. At the same time, surveys and price setting in financial markets indicated an increase in expected inflation and decreased confidence in the Riksbank's inflation target. In this situation the monetary stance was tightened. In the period from August 1994 to June 1995 the repo rate was raised from 6.92 to 8.91 per cent.

Shortly after that the Government presented a major programme for budget consolidation. Between them, the measures of fiscal and monetary policy helped to break the rise in bond rates and the krona became somewhat stronger. In the referendum on EU membership, moreover, a majority voted in favour. However, the movement towards stability did not last. Bond rates rose and the exchange rate weakened again in the spring of 1995.

The period from 1993 to mid 1995 was thus marked by unrest, particularly in financial markets. There was, however, a notable recovery in the real economy and the combination of fiscal and monetary policies helped both to turn the budget deficit downwards and to establish a low rate of inflation.

5. The stabilisation

Since the summer of 1995 it seems that confidence in the Swedish economy and in Swedish policy has improved. The krona has become appreciably stronger and both long and short rates of interest have fallen. There are plausible explanations for this:

- *Public finance* has developed better in 1994 and 1995 than many observers expected. This has to do both with the strong economic development and with the extensive budget reinforcements. Relative to GDP, the deficit peaked in 1993 at 12.3 per cent; the level for 1995 was 8.1 per cent and for 1997 the most recent official forecast , including new budget measures presented in April 1996, is 2.7 per cent.

If the present economic slowdown turns out to be deeper than expected, additional budget reinforcements may be needed. The Government and the Riksdag, Sweden's parliament, are firmly committed to the goal of balanced public finance in 1998. The situation is being followed continuously in accordance with the principles incorporated in Sweden's convergence programme. On each occasion in the six-monthly monitoring process the Government has tightened its policy to the requisite extent.

- The *picture of inflation* has also improved in the past six months. Current inflation, as measured by the CPI, was 2.7 per cent last November and this March it had fallen back to 1.7 per cent. This has been accompanied by a drop in expected inflation, as measured in surveys or from price setting in financial markets. Most agents now consider that in the coming two years the rate of inflation will be inside the tolerance interval of ±1 percentage point that surrounds the Riksbank's inflation target of 2 per cent.

The improved picture of inflation reflects an enhancement of confidence in economic policy, manifested for instance in a stronger exchange rate, though it also has to do with weaker economic activity. There are signs, moreover, that the Swedish economy now has a lower inflation propensity. Such a tendency is also suggested by the increased competition in some markets for goods and services in wake of deregulation and EU membership. Proof of this will have to await the next economic upturn.

Problems exist, however, in the labour market. Despite the high unemployment, the annual wage increases in 1996 and 1997 are likely to average around 5 percent. In the coming years this does not represent an acute threat to the inflation target. But it does limit the scope for monetary policy and makes a reduction of unemployment more difficult.

6. Sweden and Europe

Sweden's economic policy in the 1990s, with its emphasis on low inflation and stable conditions for production, has been inspired and possibly speeded up by developments in the European Union. By this I do not mean to imply that Sweden either could or would have wanted to continue its policy from the 1970s and '80s if a policy realignment had not occurred earlier in the Union.

A largely open approach to the rest of the world is a traditional feature of Swedish economic policy. Swedish companies have been successful internationally and free trade has given our country a share of the benefits inherent in an international division of labour. It is therefore natural for Sweden to participate in the single market which the European Union has now become. It is also natural for us to oppose the tendencies that sometimes appear in the Union in favour of protectionism against the rest of the world. Such tendencies are evident in many contexts. At present we are encountering them, for instance, in the discussions in Frankfurt about the appearance of banknotes and coins or about the securities that are to be eligible for purposes of monetary policy.

The Riksbank takes a positive view of a Swedish participation in EMU, seeing this as a natural development of economic cooperation in Europe and one that should be able to contribute to stability and increased prosperity.

The issue of whether or not Sweden will wish to participate in EMU, and at what time, is a political matter that the Riksdag is to decide in 1997. A Swedish declaration on this matter was placed on record in connection with the completion of the negotiations for Sweden's membership in 1994 and it is very much a political reality. Irrespective of this, however, the Riksdag is broadly agreed that the Swedish economy is to fulfil the Maastricht criteria for government finance, inflation, interest rates and so on. That is what our country needs, under any circumstances, in order to ensure a stable development.

The Riksbank is leaving the door open for Sweden's participation in EMU with effect from 1 January 1999. Today the Government and the Riksdag are firmly intent on meeting the budget criterion by 1997 and on reducing government debt, as demonstrated most recently in this April's economic policy bill. Conditions exist for fulfilling the convergence criteria by 1997.

The creation of a successor to the current form of exchange rate cooperation, the ERM, is a reasonable step towards phasing in national exchange rates in the run up to EMU. In our opinion, however, it should be possible for a country to have an inflation target, of the type used at present in Sweden, as a direct policy goal. Our basis for this view is that price stability is the paramount goal for EU monetary policy. The ultimate foundation for exchange rate stability lies in the ability to keep inflation down.

Sweden's experience from 1992 supports this opinion. We have also taken note of the subsequent success in restricting inflation and creating economic stability. The road to a stable currency must be travelled, under any circumstances, by directing economic policy in general for stability and not just by issuing declarations about a fixed rate.

From these starting points and considering that the ERM is no longer what it was at the time of the Maastricht Treaty, we have rejected a strict interpretation of the membership criterion which stipulates that any country wishing to participate in EMU must previously have been a participant in the ERM for two years. Neither do we consider that membership of a new exchange rate system should be mandatory for countries that remain outside EMU. It should also be possible, provided all criteria - including the stable currency provisions - are fulfilled, to become an EMU member at a later date.

At the same time we appreciate that there is concern in Europe that the so-called outs might use their situation to devalue their way out of problems, although what happened when the ERM collapsed in 1992-93 can hardly count as competitive devaluation. Consequently we have indicated a willingness to support a system with strict oversight, with the continuous monitoring of both inflation and budget policy. It is hard to see why a country that properly abides by EMU standards in both these respects should have problems with its exchange rate.

What really matters, in our opinion, is thus that a country has instilled fundamental stability into its economy and its currency. Only then does exchange rate cooperation become meaningful. We have also said that this stability may need to be confirmed by participation in the exchange rate cooperation for a period prior to actually joining EMU. This applies both in connection with the establishment of EMU and later, when the Union is already functioning.

7. Conclusion

The first half of the 1990s has been a dramatic period for Sweden's economy. A policy realignment - aimed at creating stable conditions for production, with low inflation and an improvement in the workings of the economy - was implemented at the beginning of the decade. The purpose was to break away from the partially destructive line of economic policy that had been followed in the 1970s and '80s and adhere instead to the good economic development which Sweden had previously experienced for almost a century. The realignment was also inspired by developments in the EU and its implementation coincided with Sweden's application for membership of and accession to the Union.

Inflation in Sweden has now been low since 1992. This has contributed to the creation of good policy conditions for stabilising production. Conditions now exist for permanently low interest rates. The industrial base has undergone a rapid expansion and productivity growth has been favourable. Government finance has been improved but unemployment remains high.

Steps have been taken to make the economy function more efficiently but more can and should be done. This applies primarily perhaps to the labour market and wage formation, where major adjustments are now required so that unemployment can be reduced. But public sector activities and the public expenditure systems in other respects also need to undergo considerable changes so that good conditions can be created for growth.

To sum up, in recent years Sweden has become more like other countries in northern Europe.