Sweden and EMU

Address by Mr. Lars Heikensten,
Deputy Governor, Sveriges Riksbank

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First, a word of thanks for being asked to attend this seminar and talk about Sweden and EMU. That EMU is now attracting increased attention in Sweden is both important and welcome. At the Riksbank we want to contribute to the best of our ability. It is also a good thing that more Swedish voices with different opinions are being heard in the debate. The committee appointed by the Government to assess EMU can be expected to make a notable contribution.

For some time now the European Union has been engaged in intensive preparations for economic and monetary union (EMU). These matters also feature prominently in the Riksbank's daily work, including my own. A large part of my and other Riksbank officials' working hours is devoted to the agenda in Brussels and Frankfurt.

The political assessment of whether or not Sweden is to participate in EMU is clearly not the Riksbank's concern. The plan at present is that this issue will be decided by the Riksdag, Sweden's parliament, in the autumn of 1997. The Riksbank is contributing to the preparations for EMU with a view to making the timetable feasible - whether or not

Sweden participates right from the start. Far from anticipating the Riksdag's appraisal of whether Sweden should participate or not, this will put the Riksdag in a position to choose either way. The Governing Board of the Riksbank has come out, however, in favour of EMU.

Today I want to concentrate mainly on two issues. First I shall consider some of the arguments being put forward in the Swedish debate on EMU. Having done so, I shall look somewhat more closely at two questions that are now topical in European cooperation. These are the stability pact and how the relationship is to be arranged, once EMU has been established, between the countries that are participating and those that are not.

EMU a part of EU's development

In order to appreciate EMU's significance, the fundamental ideas need to be seen in a broader context. The EMU process is enshrined in a treaty that has been ratified by all the EU's member states. The Maastricht Treaty in turn evolved from the original Treaty of Rome, from 1957, and the fundamental objectives of the whole concept of European cooperation apply equally to EMU.

EU cooperation is a process; it does not have to be conducted at a predetermined rate, neither need there be a clearly defined destination. The cooperation between the member states is a matter of give and take, with the intention of ultimately benefiting all concerned. Sweden is naturally a part of this. Our participation in the EU is a political manifestation of our interest in taking part in the ongoing process of European integration. Of course the cooperation presupposes that we are represented in the bodies and assemblies that decide the course of events. Thus, the EMU process is closely associated with political aspects of the integration of the member states.

As a result of the integration which has been in progress in Western Europe for some time, the countries have become more economically interdependent. Trade between the member states has grown faster than trade with the rest of the world. The integration has led, not so much to specialisation *between* industries as to a division of labour *within* industries. In their economic structure, the EU countries have accordingly become more uniform. EMU will now consolidate this progress along the road to integration and facilitate further gains by removing the obstacles which may arise through currency unrest. This will cut the cost of intra-European economic transactions and the trade risks inherent in devaluations will be eliminated.

At the same time it is clear that EMU also entails risks. Economic paths may diverge, making it difficult to cope with a single currency. The need to adjust is accentuated in the labour market, in fiscal policy and so on. Problems may also arise in the implementation of EMU. It will not be possible to predict exactly what the consequences will be because this will depend on the ability to adjust.

Without wishing to belittle the doubts that may be voiced on this count, I want to point out that this is a problem which applies to *any* social change; it is just as impossible to predict exactly what would happen *without* EMU.

Not all that different

Prior to joining the European Union, Sweden was already an active participant in west European economic integration, though EFTA's free trade agreement and the EEA. There are studies which show that the structure of production in Sweden is now relatively similar to that in Germany and many other countries in northern Europe. At all events, the resemblance is not less pronounced than between the countries for which EMU participation is taken for granted.

This suggests that Sweden and most other EU countries would be affected in a fairly similar manner by economic shocks that arise in the *rest of the world*. This has reduced the need to be in a position to adjust the nominal exchange rates so as to influence real competitive positions in the EU. The similarities in these respects between Sweden and most other EU countries are thus greater than the differences, a circumstance that the debate has tended to overlook.

The Swedish dilemma is rather that many of the economic shocks in the past have had *domestic* causes, such as wage shocks. Our ability to counter effects of these shocks in the '70s and '80s without resorting to exchange rate adjustments proved to be limited. Recently, however, the discussion has taken a somewhat surprising turn. Many of the economists who were stern advocates of a norm-based policy in the '80s have suddenly changed their tune: the Swedish economy functions so badly, we are told, that we are not ready for EMU.

That line of reasoning has two clear faults:

- Firstly there is the element of ethnocentrism. Sweden is in no way unique. Similar functional and adjustment problems are to be found in most other EU countries. In these respects our problems are thus at least not a specifically Swedish argument for staying outside EMU.

- Secondly there is the issue of exchange rate adjustments. Does this facility really enhance the ability to adjust the economy? Is it not more likely to delay an adjustment that sooner or later becomes inevitable?

Clearly, a good deal remains to be done to the labour market's adaptability in order to bring unemployment down - in Sweden as well as elsewhere. In Sweden's case the size of the public sector makes it also particularly important to review the public expenditure systems. But this is as urgent outside EMU as inside.

Emphasis on stability

With these comments the time has come to leave the more general discussion of EMU and consider some matters that, from the Riksbank's vantage point, are highly important for Sweden's relationship to EMU.

The Maastricht Treaty contains some familiar provisions that underscore the importance of economic stability as a condition for proceeding to EMU. Two of these criteria are a government deficit of not more than 3 per cent of GDP and that government debt, if it exceeds 60 per cent of

GDP, is at least being reduced. Low inflation and a stable exchange rate are also required.

In this context, too, the degree of structural uniformity is important because it influences the size of the strains that might arise in the individual countries when the Union is exposed to shocks. A relatively uniform economic structure means that economic policy reactions can be symmetrical. Conversely, structural discrepancies can give rise to inter-country differences in economic development that increase the risk of differences between national economic polices. Here we have a risk of uncertainty arising about how a sustainable long-term development for the Union as a whole can be ensured.

The Maastricht Treaty lays down an institutional frame for economic policy, with the intention of enhancing the credibility of the long-term focus on stability. Individual countries can, of course, attain a high degree of credibility on their own, as Switzerland, for instance, has shown. For countries that lack this status, however, building up an equivalent position would presumably take time. It may help to accept the common framework afforded by EMU.

The basic construction of EMU - a community aiming for stability - has become even clearer through the proposal to supplement the Treaty with a ‘stability pact’. This is intended to safeguard continued stability after EMU has been established. The discussion about ‘ins and outs’ - the relationship between the member states that participate in the euro area and those that, for varying lengths of time, do not - is likewise highly relevant for the future of EU's overall stability.

The starting point for the discussion of the stability pact is the necessity of having clear rules that bound the development of national fiscal policies; otherwise, negative effects may arise on stability in the Union as a whole.

This general idea has earned considerable support among the EU countries, including Sweden, though agreement has still to be reached on a good many details. Not the least of these unresolved issues is how the processes for guaranteeing consistent fiscal policies can be made sufficiently clear and possible to monitor. It is partly in this field that the discussion is currently concentrating.

It is right that fiscal policy rules be established in advance as clearly as possible so that conditions are the same for every participating country. Fiscal policy must be directed so that excessive budget deficits can be avoided in connection with economic slowdowns. Given such a frame, national fiscal policies can then be permitted to vary to cope with any country differences in economic activity and other needs. Fiscal policy must also allow for public financial requirements in the longer run, for instance for future pensions. Many EU countries face major problems in this respect.

Relations between 'ins and outs'

The discussion about 'ins and outs' likewise starts from the notion of stability. Stable relationships between the euro and the currencies of non-participants presuppose good, lasting and credible convergence in economic fundamentals. There must be no doubt about the long-term course. Robust forms are needed for monetary policy coordination so that temporary exchange rate fluctuations do not result in the overall credibility being questioned.

The relations between 'ins and outs' must entail a stabilisation of *real* exchange rate trends. Much of the discussion in this area is about the role a system for stabilising *nominal* exchange rates - such as the present ERM -can play when the euro has been established.

However, when it comes to adhering to a nominal exchange rate, the member states do not all have the same background or initial position. The problems in 1992/93 took different forms in different countries. For a number of the ERM participants at that time the exchange rate moved outside what was then a narrow band only temporarily; after some months it moved back in many cases to a position relatively close to the central rates.

In other countries the deviation in the real exchange rate that had built up over a series of years was too large and the future prospects (not least for government finance) were uncertain or highly alarming. A devaluation in the prevailing ERM system would not have solved this. These countries - like a couple of states, of which Sweden was one, that were completely outside the ERM - were therefore obliged to abandon their fixed exchange rate regime. In many cases the road back to sound fundamentals and future prospects that inspire confidence has been a long one. But the intervening depreciation of the currencies in question was not intended and neither - it seems today - has it given these countries any lasting competitive advantages.

In practice, then, ERM was incapable of ‘guaranteeing’ exchange rate stability in a world with free capital movements and a strong element of expectations in investment decisions. It was envisaged that the central banks would bail out the speculators at the band limits, which reduced the risk of currency speculation. An important argument behind the whole idea of EMU is in fact that a very close coordination of economic policies, monetary policies in particular, is needed if free capital movements are to be combined with fixed exchange rates.

For Sweden, the Riksbank's inflation target was the only realistic benchmark for monetary policy after the move to a flexible exchange rate in 1992. This policy has also produced good results. A gradual economic recovery has been combined with low inflation. Confidence in the Swedish economy now seems to have become appreciably stronger, leading to an appreciation of the krona and declining inflation expectations.

Against this background we have argued that in the coming third stage, when exchange rates in EMU have been locked, it would be natural for the coordination of monetary policies between ‘ins and outs’ to be arranged in the first place with a mutual inflation target. If the ECB and the central banks of the non-participating member states have equivalent targets, the convergence towards price stability would be made distinct.

ERM continues as ERM2

Still, everything suggests that a new exchange rate arrangement - ERM2 - will be set up and become the dominant mechanism, when Stage Three begins, for the coordination of monetary and other economic policies between ‘ins and outs’. The risk of tensions in ERM2 will be less than in the earlier ERM because convergence in the EU is now better than before. Moreover, the bands surrounding the central rates are considerably broader today and will probably be so in ERM2 as well. There is also a wider understanding that the real exchange rates have to covary if the nominal exchange rates are to be maintained without tensions.

It is unlikely, however, that ERM2 will be mandatory for every ‘out’. This is as it should be because for some countries the economic stability may be easier to achieve with other means. The experience in Sweden is that an inflation target functions properly.

The current discussion concerns the purely practical functioning of the new exchange rate system. Another issue is whether participation in ERM2 for a certain period is to be required, as many member states consider, for full participation in EMU. There is agreement, however, that the requirements which have to be met by the first group of participants are to be the same as for later EMU candidates.

Regardless of whether a country outside the euro area joins ERM2 or adheres to an inflation target, it is important to bear in mind that the Treaty objectives for economic policy apply to *every* member state. Compliance with the convergence criteria and participation in EMU are intended to make it easier for countries to fulfil these objectives. But the countries which remain outside for varying lengths of time have also undertaken to work for the objectives and, to this end, try to meet the convergence criteria. Thus, the direction of economic policy is not affected by whether or not a country participates in EMU.

If a consensus now exists on the economic policy objectives together with the measures that are needed to keep economic fundamentals moving along the proper path, it may be asked whether there is any contradiction between participating in an exchange rate mechanism and adhering to an inflation target. We believe there is. As long as the sun is shining, it hardly matters that one has taken boots or an umbrella along. But as long as the weather is liable to take a turn for the worse, it must be appreciated that generating the credibility needed to maintain a stable exchange rate is a delicate task. Establishing such credibility takes time. Sweden has made good progress but it is still too early to believe that the danger is over and long-term stability assured. Neither can we tell for certain just *when* this stage will have been reached.

Regardless of the forms for the maintenance of monetary stability in the EU, it is also essential that economic developments and policies are subjected to active, joint supervision. Underlying competitive positions (real exchange rates) must not be allowed to deviate to such a degree that unfair competitive advantages generate tensions in the process of integration. Procedures for this supervision are contained in the Treaty and perhaps they can be clarified still further.

Concluding remarks

Let me end where I began, with some opinions or perhaps rather, in this case, hopes concerning the continuation of the general debate on Sweden and EMU:

- The work of creating EMU is now being pursued with great vigour in Europe, as well as in Sweden. It appears highly probable that EMU will be achieved in accordance with the Treaty. Under those circumstances it would be admirable if a clear distinction could be made in the Swedish debate between assessing EMU as a whole - as an element in the process of European integration - and assessing the consequences of just *Sweden's* participation in EMU.

- There also seems to be a common notion in the debate that, by standing aside, Sweden would be able to implement an economic policy that was completely different and less stringent. That is not the case. We have an interest, under any circumstances, in achieving a stable development, with rising employment, in a world with internationalised financial markets. This is a matter, for instance, of consolidating government finance, maintaining low inflation and refraining from conducting exchange rate policy at the expense of others. In other words, the direction of economic policy will be broadly the same in every member state.

- Finally, the EMU issue must be considered in a time perspective. Personally, I do not find it particularly likely that in the long run Sweden will want to remain outside a European monetary cooperation that functions properly. Seen from this angle, the question is rather *when* Sweden should join. The advantages of waiting are that additional time is gained which could possibly be used for adjustments and that after a year or two it will be clearer what one is joining. But waiting also entails costs. Confidence in the Swedish economy may suffer, leading to higher interest rates, which in themselves could complicate the adjustment. Sweden might also lag behind in European cooperation, with less chance of exercising an influence in other matters as well.

With these three starting points, the future debate may be more realistic. Moreover, the EMU issue will then no longer be quite such a fateful matter.