

Speech

Governor Urban Bäckström

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The European Union and Monetary Union - recent developments and Swedish viewpoints

*Remarks by Mr. Urban Bäckström, Governor, Sveriges Riksbank
at the EEP Study Days in Stockholm*

First a word of thanks for the invitation to discuss with you the growing economic and monetary cooperation in Europe as it appears from a Swedish horizon. The 1st of January 1999 will probably see the start of one of the most far-reaching projects that has ever been launched in the European field.

The EMU project has various dimensions. The first is political, in the sense that the introduction of a single currency calls for political decisions. Secondly there are the macroeconomic requirements - the need to fulfil the convergence criteria so that the monetary union is stable and the euro is a strong currency. Thirdly, EMU presupposes that a new financial infrastructure is established in Europe. The implementation of a European monetary policy calls for standardised regulations and a common system for transactions. In this way EMU is - in itself - a step along the road to a single market in Europe.

I shall be talking about how far Europe has got in the EMU process and whether all the details will be finalised on time. I shall also be looking at Sweden's relationship to EMU and how we are preparing for it. First, however, I should like to consider one of EMU's basic ideas and its affinity with a Swedish tradition.

SVERIGES RIKSBANK

Telephone
+46 8 787 00 00

Telefax
+46 8 21 05 31

E-mail
registratorn@riksbank.se

Sweden's tradition of stability

The overriding objective of the single monetary policy in EMU is price stability. This, people sometimes argue, is the source of the Union's most serious risks. But has inflation ever been successful in generating growth, employment and prosperity? The economic performance of countries where short-run gains in growth and employment have been sought via inflation is discouraging. In the medium term their economic achievements have been poorer in almost every respect. It is in the light of such experiences that the countries of Europe have come to stress that high and sustained economic growth and employment presuppose an economic policy orientation for stability. But in order to tackle the high unemployment it is also necessary to ensure that the fundamental economic structures are working properly. Otherwise there is a risk of perpetuating the feature that has been common to many countries in recent years - jobless growth.

In Sweden there is a long tradition of basing economic policy on the promotion of stability. The inflationary period in the 1970s and '80s was actually a hiatus in this respect, though the cost of economic policy's failure for this period has been very high. This, briefly, is what happened.

Sweden had experienced a long period of price stability that dated from 1830, when the Riksdag (Sweden's parliament), after a phase of high inflation, adopted a silver standard. In 1863 this was replaced by a gold standard that lasted, apart from short interruptions (occasioned above all by the two world wars), for more than a hundred years. This was the case even under the Bretton Woods system up to the early 1970s; Sweden's currency was then tied directly to the US dollar but this in turn was based on the price of gold.

In this period from 1830 to the 1960s the annual rate of inflation averaged around 2 per cent. So for more than a century and excepting the two world wars and the 1970s and '80s, price stability has been the rule. One is truly justified in talking of a long Swedish tradition.

Neither was the stable value of money an obstacle to economic development: from the middle of the 19th century up to 1970 the growth rate in Sweden was one of the highest in the world. It was rather the case that the favourable trend was promoted by the low rate of inflation and the associated stability.

After the collapse of the Bretton Woods system in the early 1970s it proved difficult, however, to establish an equally stable fixed exchange rate regime. Economic policy and wage formation no longer had an explicit "anchor". Sweden experienced a series of devaluation cycles, fiscal policy was expansionary, wage formation did not function properly and structural imbalances accumulated. Deregulation of the financial sector - although necessary in itself - brought the problems to the fore.

In the 1970s and '80s, growth in Sweden weakened in relation to other countries. Even so, the economy tended to overheat and this, together with the build-up of public activities, kept unemployment *temporarily* in check. In the longer run, however, the situation was not sustainable. An inflationary, speculative bubble cannot grow indefinitely; sooner or later it is bound to burst. Moreover, the scope for a further increase in publicly-financed employment was limited. In the late 1980s the Swedish economy was in need of structural adjustments.

In the early 1990s the situation turned into a profound crisis. Output fell continuously for three years, by a total of around 6 per cent, and registered

unemployment shot up to almost 9 per cent. Government finance also deteriorated, causing the budget deficit to grow to more than 12 per cent of GDP. This was accompanied by a serious crisis in the bank sector.

The recession proved to be much deeper than anyone had envisaged, largely because the economic imbalances had been allowed to accumulate for so long and the adjustments coincided with weak international activity.

The 1970s and '80s illustrate how a period of inflation leads to economic uncertainty and instability. Inflation also tends to generate a speculative mood and short-term economic thinking. In this way the long-term conditions for production are gradually impaired.

By the same token, we are now experiencing a steady improvement in the conditions for Sweden's economy. Low inflation is being accompanied by a trend towards a balanced government budget and even a surplus. This in turn is laying a foundation for a sustained improvement in growth, which is essential for generating increased employment.

Preparations for EMU

Hardly a day passes without the media discussing whether EMU will start on time and to what extent the convergence criteria will be met. Considering the political will that has been invested in this project, the probability of monetary union being established in 1999 must now be regarded as fairly high. At the same time, the macroeconomic conditions for a timely start are only one face of the coin. The other face is the changeover's practical arrangements, which could cause delays if they are not finalised. The preparatory work in the EMI is therefore proceeding at an undiminished rate so that everything will be in place for a start in 1999. Many aspects of the EMI's work are already nearing completion; in a number of cases all that remains is to test the systems. Today, most things suggest that there will be time to complete the preparations.

The decision about which countries will constitute the euro area is due next spring. It will entail the establishment of the European System of Central Banks (ESCB), which will consist of the European Central Bank (ECB) and the national central banks (NCBs). The objective of the ECB is to be price stability and the ECB will have three decision-making bodies. The supreme body is the *ECB Governing Council*, which will include the central bank governors of countries participating in the euro area. The principle is that each central bank governor has one vote, which means that, formally, no country exercises more influence than the others. Moreover, decisions are to be made on a factual basis with reference to the monetary union as a whole. The primary task of the Governing Council is the formulation of monetary policy. Council decisions are then to be implemented by the *Executive Board*. Thirdly there is the *ECB General Council*, which will include the central bank governors of all EU countries and have the task of preparing for the participation of countries that are outside the euro area. The General Council, however, will not be in a position to influence the single monetary policy. This means that countries outside the euro area will not have a say in monetary policy decisions but will directly or indirectly be affected by them.

Technically, the establishment of the ESCB and the ECB calls for something like a large-scale merger of the national central banks. The ECB is to be a separate legal entity with its own capital and foreign reserves, etc.

What, then, will happen in the ESCB on the 1st of January 1999? First of all, exchange rates will be locked and the euro will become an independent currency. The ECB will begin to implement the single monetary policy. In this respect the central banks of countries in the euro area will function as extensions of the ECB, while the central banks of non-euro countries will continue to be responsible for monetary and exchange rate policy. The latter countries have the option of participating in ERM II, which will largely resemble the present exchange rate mechanism. Participation is thus to be voluntary but a country that chooses to be outside ERM II will still be required to treat exchange rate policy as a matter of common interest. The reason, of course, is to prevent non-euro countries from obtaining undue competitive advantages via depreciations.

Preparations in Sweden

For reasons to do with foreign policy, Sweden remained outside European cooperation for a long time. With the fall of the Berlin Wall in 1989 and Sweden's increasingly strained economy, the attitude to EU membership slowly changed. This resulted in negotiations during 1993 and after a referendum in 1994, Sweden joined the European Union from 1995. As regards the monetary union, however, there are many indications that Sweden will not be participating in the euro area from the start on 1st January 1999. This was the message from the executive of the Social-Democratic Labour Party in June. The reasons given included the negative public opinion in Sweden. The question is now being considered by the Social Democrats' Congress. Parliament is to vote on the matter this autumn. At the same time, it is said that Sweden is to have a high state of readiness for participation later on. Thus the Riksbank continues with the preparatory work to ensure that a choice exists in practice. It should be underscored that Sweden's macroeconomic conditions for belonging to the euro area are good. Step by step, developments in recent years have resulted in marked progress towards fulfilment of the convergence criteria.

For some years now the Riksbank has been engaged in practical preparations for the monetary union. This has been done with a view to being ready if the Riksdag were to decide that Sweden is to join from the start in 1999. One of the primary tasks in this respect has been to inform and consult with the financial sector on matters to do with the changeover. To this end we have set up a consultative group for the financial sector. Together with this group the Riksbank issued a situation report at the beginning of 1997, dealing with what an adoption of the euro from the start would have for consequences for the financial sector. The report concluded that if Sweden were to join the euro area from the start in 1999, our financial sector would be ready for this.

A new report is now being drafted on the consequences of a situation in which Sweden does not participate from the start. As things stand, this indicates that the move to Stage Three, whether or not Sweden participates in the euro area, will involve the financial sector in far-reaching changes. The banks consider, for example, that the competitive situation will oblige them to offer various types of

euro services, above all to corporate customers but also to private individuals. This will necessitate parallel systems and thereby considerably higher costs than if Sweden were to participate from the start. The securities market considers for its part that competition will require a changeover to the euro for trading in certain securities; for these securities, trading in euro will mean that trading in Swedish kronor ceases.

In an outside position, the Riksbank will be able to use the ECB's payment system, TARGET, though the conditions for this have not yet been finalised. The TARGET system is intended primarily for monetary policy transactions but it will also take large-value commercial payments. But our national payments system, RIX, will have to be adapted so that it can handle parallel currencies.

Conclusion

At present it looks as though Sweden will probably not be participating in the euro area from the start. What will happen later on is still difficult to tell. But Sweden's central bank is taking an active part in the European preparations and is striving to ensure that Sweden has a high state of readiness for participation at a later date.

One thing is certain, however, and that is that the demands on Sweden's economic policy will not diminish. In an outside position Sweden will have to provide an even clearer demonstration of its determination to keep a firm hold on inflation and generate budget surpluses on a scale that can bring public debt down to levels that are more sustainable.

A decision not to participate from the start does not mean that the financial sector in Sweden can simply ignore the monetary union and continue as before as though nothing had happened. The creation of the inner market and a monetary union are events with fundamental repercussions on the operating conditions for banks and others in every European country, regardless of whether or not it belongs to the euro area from the start. This means that the financial sector in Sweden has every reason to adapt to the requirements that are inherent in Europe's emerging financial structure.