Speech

Governor Urban Bäckström

MONDAY, MARCH 16, 1998

Sweden and EMU

Confederation of Finnish Industry and Employers, Helsinki

First a word of thanks for the invitation to talk about Sweden and EMU. Those who follow the discussion about economic developments in Finland and Sweden are accustomed to hearing the relationship between our countries described in family and sporting terms. Who decides: big brother or junior? Who will win the international match in economic performance when the countries choose different paths? And which of them, by the way, is the big brother and which is junior? Talking in such terms is, in my opinion, wrong. Instead we can note that two *brothers* have opted for different paths in the near future. For various reasons, Finland has chosen to adopt the single currency from the start, while Sweden will be staying outside in the coming years. But we shall still be performing on the same economic playing field, under the same rules and with the same referee.

Today I shall be presenting my view of what this may entail for Sweden's economy. After a brief account of experiences in the 1980s and '90s which Finland and Sweden shared to some extent, I shall consider the preparations and prerequisites for Swedish economic policy that will apply in our position outside the euro area.

Similar experiences in the 1990s

Economic development in Sweden in the 1980s and '90s closely resembled the situation in Finland. In the late 1980s Sweden, like Finland, experienced a period of overheating that mainly stemmed from excessively strong domestic demand, generated by a rapid expansion of credit. In the early 1990s this overheating turned into a major setback. GDP fell sharply from 1991 to 1993, unemployment shot up,

Telephone +46 8 787 00 00
Telefax +46 8 21 05 31
E-mail registratorn@riksbank.se

government finances deteriorated markedly and the bank sector was hit by a crisis. Heavy pressure on the kcurrency meant that the fixed exchange rate had to be abandoned in the autumn of 1992.

In the aftermath of the exchange rate crisis, Sweden's Riksbank faced the same troublesome situation as its Finnish colleague. A new monetary policy strategy had to be chosen in a situation where confidence in monetary and exchange rate policy was low. Factors behind the lack of confidence included the earlier pattern in economic policy, with a strong inclination to resort to devaluations as a response to cost crises, together with the defeat in the defence of the fixed exchange rate.

Alternative strategies were considered, including a look at solutions chosen by other countries. In Sweden, just as in Finland, we were unacquainted with a flexible exchange rate regime; the general opinion, among economists as well as politicians, was that for a small, open economy, heavily dependent on international activity, a fixed exchange rate is the sole option. This opinion has subsequently changed.

The strategies chosen by the two central banks were broadly the same. Monetary policy targeted inflation directly and the quantified target was announced early in 1993. The Swedish target, however, was formulated somewhat more specifically: CPI inflation was to be limited to 2 per cent, with a fluctuation margin of ±1 percentage point. The Finnish target was expressed instead as a permanently stable underlying inflation rate of 2 per cent. In both Finland and Sweden, the price stability objective was a central bank commitment initially, with subsequent explicit support from the government and parliament.

The 2 per cent inflation target was to apply from 1995 onwards. In the meantime, inflation and inflation expectations were to be lowered from the high levels in the 1980s. In other words, credibility was to be re-established.

In order to promote an understanding of our policy and a broad insight into the foundations for policy decisions, the Riksbank initiated regular inflation reports. These reports, which are now published four times a year, present a clear and detailed account of how inflation is developing, our assessment of future inflation and the conclusions from this for the monetary stance.

Different strategies

Finland then changed its strategy in October 1996. The price stability target was retained but it was supplemented with an exchange rate target in the exchange rate mechanism, ERM. Reinstating a fixed exchange rate for the markka was to be seen as a preparatory step for Finland's participation in the monetary union as of January 1999.

Sweden, on the other hand, has chosen a wait-and-see attitude to the monetary union and does not intend to adopt the euro from the start. The Riksdag (Sweden's Parliament) noted that the economy had recovered and that the convergence criteria would probably be met but that popular support was too weak for participation from 1999.

Participation from a later date is not ruled out if the situation changes. The Riksbank intends to complete the preparations that are needed so that Sweden can join the euro area at a year's notice. Technical preparations are already under way in many fields, both so that the requirements for future participation can be met and in order to cope with requirements inherent in the introduction of a new European currency, requirements that have to be fulfilled whether or not Sweden chooses to remain outside.

Preparations in Sweden are also needed in the field of economic policy. What will be the implications of an outsider position in this respect? What will it require?

The debate in Finland often expresses concern that Sweden, as a country outside the monetary union, will allow the krona to depreciate and thereby improve its competitive position relative to Finnish industry. I find such statements and, in particular, the indignant tone one sometimes hears, surprising. What is perhaps most remarkable is their assumption of an outdated economic policy environment and a failure to acknowledge the monetary policy playing field that now exists for Sweden as well as Finland. It is the world in general in which we are living, not just participation in the monetary union, that sets the framework for a country's economic policy. There is less room for conducting a national policy that deviates markedly from the line in the world around us.

So I shall now discuss Swedish policy's current framework and the underlying priorities.

Future implications for economic policy

In that Sweden will be outside the monetary union initially, it will still be the Riksbank that makes our monetary policy decisions. These decisions will continue to be based on economic developments in Sweden. The construction of Swedish economic policy will comply, just as it does at present, both with the requirements that have been set up in Sweden in the light of our domestic priorities and with the requirements inherent in EU membership. Sweden's priorities and those of the European Union are broadly the same. They call for an economic policy focused on stability and low inflation. A balanced economic policy is expected whether or not a country has adopted the single currency.

Conditions for monetary policy

Statements by the Riksdag on ERM in connection with the EMU decision imply that monetary policy in Sweden will continue to be conducted as at present. The Riksdag noted that membership of the Exchange Rate Mechanism is regarded as a preliminary step for participation in the monetary union, so there is reason to suppose that the question of ERM membership will not arise until the time comes for a decision on EMU participation. Monetary policy will therefore continue to be based on a flexible exchange rate and an explicit price stability target.

As of 1 January 1999 the price stability objective is to have statutory force. The Riksbank will have a more independent status and will thereby be in a position to ensure that the objective assigned it by the Riksdag is attained. These changes have been approved by a parliamentary majority.

The amendments comply with EU requirements concerning monetary policy and the function of the central bank. Whether or not we adopt the single currency, Sweden has undertaken to have an independent central bank, which involves a farreaching delegation of monetary policy decisions on the basis of an operational objective.

Conditions for fiscal policy

Swedish fiscal policy will likewise continue to focus on the national objectives as well as on the goals that have been set up for the European Union.

A long-term objective for Sweden's public finances was announced in 1997 by the Government and approved by the Riksdag. In the medium term the government budget is to show a surplus, measured as the cyclical average, of 2 per cent of GDP. In that a surplus is generated, government debt can be reduced so that future challenges which Sweden's economy may face can be tackled without creating problems for government finances. Considering that Sweden's public finances are relatively sensitive to cyclical activity, the Riksbank considers that this objective is reasonable.

Besides the greater awareness of the importance of stable finances, the conditions for fulfilling the budget objective have been improved by institutional changes to the budget process. Sweden's revised budget process is inherently more disciplined than before and this can contribute to sounder finances.

The Swedish objective of government financial consolidation tallies with the EU budgetary objective of positions close to balance or in surplus over the medium term. The target set up by the Swedish Government is, however, somewhat more ambitious. Sweden's fiscal policy is also subject to EU agreements even though we have deferred membership of the monetary union. Under the Stability and Growth Pact, Sweden is committed to meeting the EU objective, though as a non-participant we would not incur sanctions if we failed to do so. More generally, as a member state, Sweden has undertaken to regard its economic policy as a matter of common concern to all EU member states. We will accordingly be participating in the economic policy discussions and be subjected to assessments and evaluations. We are also taking part in the drafting of the broad guidelines of economic policies; these guidelines, which can be likened to fiscal plans for the Community, are to be incorporated in the construction of EU countries' economic policies.

Implications for the exchange rate

Now for some remarks on the krona as an outsider currency.

Sweden's monetary policy strategy in an outsider position involves a flexible exchange rate and a policy focus on price stability. The Riksbank has no explicit exchange rate target; given Sweden's position on ERM, moreover, the exchange rate will continue to be flexible until we have decided to adopt the euro. This conforms to EU agreements in that ERM membership is to be voluntary. Even with a flexible exchange rate, however, the Maastricht Treaty requires us to treat our exchange rate policy as a matter of common interest.

With this strategy, the exchange rate tendency will continue to be one of several indicators for monetary policy. A depreciating tendency that is excessively prolonged on account of financial market unrest is liable to lead in time to higher inflationary pressure. In such a situation the Riksbank would act in order to uphold the price stability objective. Adjustments are likely to occur more rapidly if the pattern of the Riksbank's responses is clear, with price stability always the primary consideration. The divergences would then be short-lived.

All in all, there should be good conditions for a stable exchange rate between the krona and the single currency. There are many indications that the European Central Bank will define a price stability target that resembles Sweden's. Similar inflation trends, together with confidence in economic policy as a whole, result in stable nominal and real exchange rates between the euro and the krona. It may be worth noting that even though Sweden has not been participating in the ERM cooperation, the krona's exchange rate with the German mark has been fairly stable.

Policy results

Taken together, the factors I have mentioned—altered objectives and institutional arrangements, as well as European economic coordination—indicate the emergence of a consensus. There is agreement among politicians and central bank governors that the earlier devaluation policy created problems and was not worth its price. The repeated devaluations simply altered nominal values and were ultimately ineffective in real terms. Inflation rose and eroded the short-run gains. Readjusting to a more sustainable level of inflation was a painful process.

In Sweden we can see that economic policy is producing results in the right direction. Since the monetary policy realignment, the price rise in Sweden has matched or been below the EU average. Annual CPI inflation since the announcement of the inflation target in January 1993 has averaged 2.3 per cent. Since January 1995, when the target came into force, the average CPI increase has been 1.5 per cent. As regards fiscal policy, a notable reduction of the budget deficit has been achieved, from a peak of just over 12 per cent of GDP to the current figure of only 0.8 per cent, which is below the EU average.

Five years after the construction of the price stability target we can say that confidence in monetary policy has been restored from the low level that followed the departure from a fixed exchange rate. The new monetary policy strategy works and economic agents seem to recognise the considerations that guide the Riksbank. Inflation has been lowered and inflation expectations show that people count on the Riksbank continuing to meet its inflation target.

Future confidence

Finland will be participating in the monetary union, while Sweden will remain outside initially, with a flexible exchange rate and a price stability target. After a period with similar monetary policy strategies, our countries have now chosen different paths but will continue to aim for the same objective—price stability.

We have made good progress with Swedish economic policy and the conditions for a stable economic development are good. I feel confident in Sweden's ability to conduct a judicious policy in the future, both as regards the policy's construction and its institutional framework.