

# Speech

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## Sweden and the Euro

Swedish Chamber of Commerce for Germany,  
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Ladies and Gentlemen,

Let me begin by thanking the Swedish Chamber of Commerce for inviting me to this conference on a subject of immediate importance to Sweden and of course to the Riksbank. This is also a subject in which I have taken a strong interest for many years, as a Member of the Riksdag and also briefly as a Member of the European Parliament.

We live in a challenging time for the euro area, facing both the present downturn of the global economy, and the future enlargement to include the new EU members from Central and Eastern Europe. It is also a decisive period for Sweden, as the issue of EMU participation is now coming to the fore.

Given that we are approaching a decision on a euro referendum in Sweden the Riksbank will naturally step up its preparations to ensure a smooth and rapid transformation of Sweden and the Riksbank to the Eurosystem.

I will here today share with you some views on the development so far of the euro area and on the possible Swedish membership. My presentation will naturally focus on the economic aspects of EMU, but let me nevertheless emphasize that I personally think that the political arguments for European cooperation remain crucial, especially at times when nationalism is on the rise on our continent.

The day after tomorrow, the Swedish Prime Minister will hold consultations with fellow party leaders to come to an agreement on setting a date for a referendum on EMU. It now looks as if the referendum will be held in autumn next year. If the outcome of the referendum is a yes, the Government will propose the Swedish Riksdag that Sweden should seek an end to the derogation from full participation

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the Stage Three of the Monetary Union. The Riksbank will of course play a central role in this process, I will just briefly mention two aspects:

On the one hand there is the less spectacular but no less important preparatory work for a transition to the euro. The Riksbank has held consultations with the financial sector and with tax and social security administrations. We have estimated that at least 18 months will be required to achieve the transition, if the introduction of banknotes and coins would come later.

Another, more publicised role of the Riksbank, is that of the Swedish participation in ERM2. The exchange rate regime in Sweden is today decided by the Government, while the Riksbank decides on issues concerning its implementation. If the Government decides to join ERM2, the Swedish finance minister and the Riksbank governor will be parties to a common accord with euro area finance ministers and the ECB on a central rate between the Swedish krona and the euro in ERM2. And it is on this occasion the important step is taken, meaning a modification of the monetary regime.

There are no simple criteria for determining the most appropriate central parity rate. What the Riksbank can do is to use the various models at our disposal and combine their results with expert knowledge and good judgement to try to narrow down a reasonable interval and analyse the consequences of different choices. All models and forecasts at the Riksbank's disposal now suggest that the real exchange rate will appreciate in the coming years. The question is by how much. The different models give a wide range of estimates for the real appreciation, ranging from a few per cent up to 10 per cent from the current level. With the realistic assumption that inflation will be about the same in Sweden as in the euro area in coming years, this implies an interval for the nominal SEK/EUR rate that extends from approximately 8.20 to a little more than 9 kronor.

Even if the Riksbank thus participates actively in the preparations for euro introduction it will not, as an independent and non-political institution, be actively involved in the referendum debate. In 1997, The Riksbank's governing board took a decision in favour of early participation in the EMU as a response to the government report on EMU membership chaired by Professor Lars Calmfors. However the present Executive Board has not taken any common position ahead of the referendum, although the personal views of several board members on EMU are well publicised, including my own pro-euro stance.

### **The euro area performance since 1999 and Sweden's situation**

So what can we say about the state of the Monetary Union, some three years after its inception?

Let me first emphasize that three years is a very short time span to evaluate a project of this scale, not nearly enough for anyone to make an authoritative judgement. But, undoubtedly, for those who had great expectations regarding convergence, increased competition and higher productivity during these first three years the euro will have been a disappointment in some respects. Many were hoping that the creation of the euro, with the integration of financial markets,

increased cross-border competition and the reduced transactions costs, would usher in a period of higher growth and productivity gains for the euro area.

Instead, we have seen a slowdown in productivity and an economic performance steadily below that of the US, and also slightly below that of Sweden and other pre-in countries. Since 1999 GDP growth has on average been 2.3 percent in the euro area against 2.9 percent in Sweden, while overall productivity in the euro-economy according to the OECD has been only 0.6 percent in the euro area 1999-2001, against 1.0 percent in Sweden.

So, at least superficially, it does not appear to be the case that Sweden has underperformed because of its non-participation in the euro area. During the economic boom in 1999 and 2000 the euro area lagged behind the US and Sweden in productivity increases. And during the downturn of 2001 and 2002 Europe still underperformed the US and Sweden.

This is the reality, and of course on a very simplistic level it makes poor publicity for EMU prior to the Swedish referendum. Yet I believe that it would be a mistake to blame monetary policy or indeed EMU itself for this disappointing performance.

On closer inspection EMU as such has achieved its major objectives during the first three and a half years of existence. Most importantly price stability has been successfully achieved. Headline HICP inflation was below the stated maximum target level of 2 percent in 1999 and slightly above in the following years. However this was achieved under rather adverse conditions: during 2001 and the beginning of 2002 prices were very much affected by the triple impact of animal disease (affecting meat prices), oil prices and the changeover to euro coins and notes. Core inflation, excluding the most volatile food prices and energy, has been reasonably close to the 2 percent level 1999-2002. Inflation expectations also appear to have been firmly anchored close to 2 percent.

Now there has of course also been quite a high degree of divergence inside the area, with inflation ranging from over 5 % in the Netherlands to 1.8 % in France in 2001 (and even lower figures in Germany during 2002). This has created differences in real interest rates, but not wide enough to explain the overall lag in productivity or growth.

None of those caveats can explain the euro area's poor performance. The overall macroeconomic climate is not the problem, in fact it has been rather favourable.

I might add that the macroeconomic environment has been rather favourable in Sweden too. The period from 1999 has underlined that confidence can be achieved outside EMU. HICP inflation in Sweden has actually been lower than in the euro area, our price developments have also been in line with our inflation target, as have inflation expectations. The interest rate differential between Swedish and German bonds has been firmly in the low decimals and has even for a short period of time been negative.

If overall macroeconomic conditions have been favourable, both in the euro area and in Sweden, the real issues and problems are not in macroeconomic policy, but on the structural side, in product markets and in labour markets.

In the euro area the recent fall in productivity in the business sector and increase in unit labour costs seem to reflect a high degree of labour hoarding, that is to say a refusal to cut staff when faced with lower demand, and thus poor reallocation of employment. There might be good reasons for this, such as high costs for finding and training the right personnel in a competence driven economy, but it nevertheless indicates that wage flexibility needs to increase. And despite this overstaffing, wage growth has not slowed down.

Similarly, studies from the OECD and recently published research highlight that the important differential in growth between the US and Europe is the poor employment growth in Europe. The US certainly has the advantage of having a young and growing population, but Europe has large numbers of unemployed or underemployed people who could become mobilized for increased growth of the economy. This need not imply that Europe must adopt US hiring and firing practices, there are other ways of achieving this, with economic incentives, labour market policies and education.

### **Challenges for Sweden ahead of a possible EMU participation**

Wage formation is also an important challenge for Sweden prior to a possible EMU participation.

The main issue after a possible participation in the euro zone will be the loss of the exchange rate and an independent monetary policy as stabilisation tools. If Sweden, within EMU, is out of step with the business cycle in the euro area, neither an exchange rate, nor Swedish interest rates are available to adjust for this.

In reality, the exchange rate may in fact be a less efficient stabiliser than expected. It is quite apparent that macroeconomic fundamentals and Sweden's position in the business cycle have not been the only, sometimes not even the major, factors affecting exchange rate developments. If the weakening of the krona in 2001 did indeed cushion the blow from global recession, earlier periods of weakness have run counter to the overall improved relative growth performance.

Personally, I believe that there might be a tendency in the Swedish debate to overstate the gains from having a flexible exchange rate in the longer run. Our recent experience shows that a small currency on the highly volatile financial markets risk being more affected than the bigger currencies by factors out of its control and with no direct relevance to their economic performance. One such example was the reaction on the currency markets in the days following the 11 September events. It is also quite apparent that the present strengthening of the krona was influenced by the Prime Minister raising the issue of a referendum on EMU.

Furthermore, recent experience implies that the deviations from the euro average growth should not be very large in the normal case. Even if Swedish growth and productivity have been somewhat higher than those of the euro area since 1999, recent evaluations show that that the business cycles in the euro area and Sweden are fairly synchronised, despite the asymmetric shocks due to the crises in the mobile telecommunications and IT sectors.

However, it cannot be ruled out that Sweden can become subject to serious asymmetric shocks, i.e. disturbances affecting Sweden differently from the rest of the euro area. On those occasions it is important that Sweden has an alternative way of stabilising the economy.

One possible instrument is of course to use fiscal policy. The Riksbank recently presented its views on the government report "Stabilisation policy in the Monetary Union" where we elaborate on the possibility of using fiscal policy to stabilise inflation in a similar way as monetary policy does today. This implies that fiscal policy is given a clear mandate, with clear targets, strong institutional arrangements and a high degree of openness. Of course, using fiscal policy as an effective tool additionally implies a strong budgetary position over the cycle - which is also important given the present demographic trends which point to increased costs for supporting an ageing population.

I believe this discussion could also be of some interest in relation to the present debate on the Stability and Growth Pact, as it stresses the importance of strengthening the institutional framework and the long term goals for national stabilisation policies in the monetary union, as opposed to a more passive policy simply letting automatic stabilisers take their course. And, like Sweden, the euro area needs a strong fiscal stance in order to cope with the future fiscal burden of ageing populations.

Even more important than the alternatives for stabilising the economy are the structural reforms which are needed to increase potential growth and contribute to an economy more responsive to changing circumstances. If this is done successfully the problems of instability will probably not arise or will be of less significance.

As we analyse Sweden's labour markets it is worrying that unit labour costs have increased slightly more rapidly in Sweden than in the Euro area recently. As the possibility to conduct an independent economic policy decreases, the need for functioning adjustment mechanisms increases which implies greater flexibility in factor and product markets in Sweden. This flexibility in the labour market could apply both to increased variability in nominal wage increases and to increased professional and geographical mobility of the labour force.

### **Potential gains from euro membership**

So far I have concentrated on some of the disadvantages of joining Monetary Union. But let there be no mistake, there will certainly be important gains from EMU for Sweden. While large Swedish corporations already enjoy many of the advantages of using the euro, being already well integrated into the European market, joining the euro area may be essential for small and medium sized enterprises, which are too small to use advanced methods of handling exchange rate volatility. A recent survey revealed that 80 percent of the larger corporations in Sweden already invoice in euros, compared to only 15 percent of the small and medium-sized enterprises.

Our overall macroeconomic models do not always capture the strength of these microeconomic forces at play at company level when transaction costs are reduced and barriers for trade and investment lowered. Some of the recent research, such

as the gravitation models presented by Professor Andrew K. Rose and others, which compare wide sets of countries, give very significant increases in trade and growth from currency unions. Similarly, comparisons of the remarkably high price differentials between comparable and neighbouring areas in the US and Canada indicate that the existence of price transparency affects prices. Today we focus very much on the price increases on some services after the introduction of euro coins and notes, but let us bear in mind that prices on durable goods that are more subject to cross border comparisons, have indeed increased less than the average or even decreased. There are already signs of a convergence of prices on such durables and there is also area-wide euro pricing from some firms, which reflects increased price competition across borders.

To conclude, the Monetary union presents an attractive proposition for Sweden, given that we continue to improve the functioning of wage formation and labour markets and that we ensure a solid institutional foundation for fiscal policy to stabilise the economy. The same could in fact be said about the euro area countries: With structural reforms and more solid foundations for fiscal policy, the present EMU-countries would have much better possibilities for employment growth and productivity gains. Monetary Union is putting pressure on both industry and politicians to improve their performance in the years to come.