Speech

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Euro, SEK and EMU

World Trade Day '98

I should like to begin by thanking our hosts for the invitation to World Trade Day '98.

The introduction of a new currency is due in our vicinity in little more than four months time. This is the first instance in modern times of a large group of sovereign states establishing a monetary union with a single currency. Along with the collapse of the Iron Curtain, the creation of the European Monetary Union is probably the most significant European event since World War Two.

Today I shall be focusing on what the birth of the euro may mean for developments in the currency market. I shall not, however, be attempting to predict the euro's future strength or weakness. Instead, I shall begin by discussing factors that could affect the single currency in the course of the changeover and the somewhat longer term. Then I shall consider how the euro is likely to affect the position of Sweden's currency, the krona. I can say right now that, basically, I do not believe that the euro will fundamentally alter either the role of the krona in Sweden's economy or, for that matter, the value of the krona in the long run. In view of the discussion that this matter occasions from time to time, there may be reason to say something about the view of the Riksbank.

1. A new currency is created

A new currency will see the light of day in January 1999. Eleven countries in Europe are forming a monetary union and will accordingly be having a currency, a monetary and exchange rate policy and a central bank in common.

The euro will be the domestic currency of a major economic area. Today, the euro area's share of world output is around 30 per cent, as against around 35 per cent for the United States. As regards world trade, the share for EMU's external trade amounts to around 17 per cent and the United States around 15 per cent.

EMU is a central component in the process of European integration. This process was initiated in the 1950s with agreements on the joint control of certain means of production, the European Coal and Steel Community. The idea was to forge economic bonds between nations as a way of promoting peace in Europe. The establishment of the Common Market in the 1980s was a further step, aiming at freedom of movement within the Community for goods, services, capital and individuals. With the introduction of a single currency, the countries of Europe will come still closer to each other in economic and political terms. At the same time, yet another obstacle to the creation of a large internal market in Europe will be removed.

Thus, EMU is to be seen primarily as one aspect of a larger, political project. Most analyses, however, have tended to concentrate on the union's pros and cons in an economic context. The advantages that have been cited for the participating countries include lower transaction costs for trading in a common currency, increased transparency and competition in the single market, and low, stable inflation. The lack of an exchange rate as an instrument for stabilisation policy is mentioned as one of the drawbacks.

Sweden's Parliament decided in December 1997 that Sweden would not be joining the monetary union from the start, mainly on account of the lack of public support. The decision was made after a committee of experts had reported on participation's advantages and drawbacks for Sweden. The commission was basically in favour of Sweden being a member of EMU but was of the opinion that, given the disadvantages considered, Sweden should not participate from the start. The costs in terms of stabilisation policy were assumed to exceed the benefits from economic efficiency. The report's assessment of political aspects favoured Swedish membership of EMU.

The report gave the Riksbank an occasion to present its appraisal of the monetary union. This differed and amounted to a recommendation that Sweden should participate from the start. We considered that the commission had overestimated the costs for stabilisation policy, while the economic and political benefits were likely to be even greater than envisaged in the report. Since the compilation of report, moreover, the political reasons for participating from the start have grown in that more countries than expected will now be members from the beginning.

2. The euro's stability

The euro will exist as an account-based currency as of next January. While banknotes and coins denominated in euro will not yet be in circulation, it will be possible to make transactions in euro. So what will be the euro's role in currency markets? Will it be stable? And will it compete with the dollar as an international reserve currency?

As we all know, predicting exchange rate movements is difficult. In general, one can say that a currency's nominal exchange rate is determined by the real exchange rate together with differences in inflation with the rest of the world. A currency's real exchange rate can be described as the price of goods and services in that country relative to the rest of the world. If a difference in inflation grows, a corresponding depreciation of the currency is needed to keep the real exchange rate stable. The current exchange rate is also influenced by expectations of future rates. The credibility of economic policy's commitment to long-term price stability is thus important for exchange rate tendencies.

The value of a currency is also susceptible to influences of a more temporary nature. Cyclical factors may play a part. When the economy is in an upward phase, a country may need a tighter monetary policy, which normally leads to an appreciation of its currency. Deviations from the exchange rate's more fundamental level may also be occasioned by matters to do with credibility. In addition, the exchange rate may be affected by transitory shifts in the currency market's demand and supply. Such shifts may arise from portfolio adjustments. In certain periods these mechanisms may tend to accentuate exchange rate movements even though economic fundamentals point in a different direction. One example of this is the large movements in the US dollar.

Against this background I shall now look at some factors that will probably be important for the development of the euro. I shall take the fundamentals first and then point out some factors that could be of transitory significance for the euro.

Fundamental factors

Provided economic policies in the euro area focus credibly on price stability—accompanied by a corresponding low-inflation policy in the rest of the world—it is probable that the euro's nominal exchange rates with other countries will display a high degree of stability. However, cyclical disparities between currency blocs and some uncertainty about monetary policy signalling are factors that could generate certain fluctuations.

EMU is constructed so that monetary policy will be formulated collectively by the ECB's Executive Council and the national central banks in the light of the overall picture of inflation in the euro area, while fiscal policies are formulated at the national level.

Monetary policy

The European Central Bank (ECB), which will be accountable for EMU's single monetary policy as of next January, was established on July 1st. The monetary policy objective is price stability. The objective has not yet been defined more specifically but statements suggest that there will probably be an intermediate money supply target and that price stability will be represented by an inflation rate of 2 per cent or less. The latter has raised the question of whether Sweden ought to revise its inflation target. The question is somewhat premature in that the ECB's target formulation has still to be finalised. Moreover, the suggested formulation is in line with what has applied in Germany, where on average in recent decades monetary policy has not resulted in a rate of inflation below 2 per cent. In view of this, together with the advantages of an inflation target that is symmetrical, there are no grounds at present for considering any change in Sweden's inflation target.

The ECB has been given a high degree of independence in fulfilling the price stability target without any short-run political considerations. The institutional conditions for monetary policy credibility are accordingly good.

By itself, however, this is not enough. Credibility must also be achieved continuously, through a responsible monetary policy that is properly understood and supported by society in general. At first there may be considerable uncertainty about how the single monetary policy functions and how signals from the ECB should be interpreted. Much will therefore be required initially of the ECB in explaining its policy, presenting the analyses behind its decisions in an understandable way and creating a broad understanding of the monetary policy in every part of the union. This understanding may be tested particularly severely if price pressure in a particular country deviates from the average so that the repo rate is not perceived as appropriate to the national situation. The national central banks in the euro area should be able to lend a hand here, both in communications with the public and by providing sound analyses of tendencies in their home country.

This brings me to the discussion about the ECB Governing Council. Concern has been voiced in the debate because the composition of the Council, the ECB's supreme decision-making body, might lead to policy being influenced by strong national interests at the expense of the total picture. One source of this concern is that so many of the Council's decision makers are national central bank governors, who might allow for national interests. Comparisons are made with the US Federal Reserve, whose decision-making body has a smaller proportion of regional governors. Another cause of this concern is that political accountability in the European Community is essentially exacted at the national level; it is largely in the national arena that economic policy is discussed. While these problems cannot be dismissed out of hand, I believe they have been exaggerated. The members of the Council are jointly responsible for making the ECB a success and establishing price stability in the euro area. In this sense they are all in the same boat and nothing is more likely to capsize the boat that a national preference. That, I believe, will characterise what happens in practice.

In any event, a distinct, transparent policy right from the start is vital in order to avoid unnecessary uncertainty that could result in exaggerated movements in exchange rates and interest rates.

Other components of economic policy

In the long term it is the construction of monetary policy that determines the rate of inflation. In the shorter run, however, price movements are also influenced by other economic factors. Other components of economic policy—that is, fiscal, labour-market and structural policies—therefore have to be constructed so that they support the policy drive for sustainable price stability. If these components do not work, the burden on monetary policy becomes additionally heavy.

Economic policy apart from monetary policy will continue to be a national matter in the euro area, even though it is the subject of agreements at Community level.

Fiscal policy will still be constructed by the national governments, though to some extent its scope is restricted by the Stability and Growth Pact, to which all the EU countries subscribe. This Pact requires each country to conduct a responsible fiscal policy, defined as achieving a general government budgetary balance or surplus over the medium term. Each country is also to allow continuous monitoring of its government finances by the other EU countries. A government budget deficit is normally not to exceed 3 per cent of GDP, though there is room for certain exemptions. If a country in the euro area does have a budget deficit above 3 per cent and this cannot be explained by factors that are exceptional and temporary, sanctions are to be imposed. EU countries outside the euro area are not liable to sanctions, however; they are only included in the monitoring provisions of the Pact.

The task of establishing price stability in the euro area will be facilitated if low inflation in the area is also promoted by fiscal policies. The importance of fiscal policy lies both in creating sustainable government finances, which contribute to the general credibility of economic policy, and in countering tendencies to excessive price pressure in the economy. In that the single monetary policy is to be constructed in relation to the overall situation in the euro area, more will be required of fiscal policy in the context of national stabilisation policy—fiscal instruments will still be available for stabilising national economic trends. But this in turn does presuppose that there is room for manœuvre in the national budgets. Partly on this account, the Stability and Growth Pact's medium-term objective of a government budget balance or surplus is reasonable and it is highly important that the countries meet this undertaking. Today this is the case in just a few countries, of which Sweden is one.

Monetary policy's interaction with fiscal policy will be important, at both national and EMU level, for the perceived credibility and consistency of economic policy in general. A constructive dialogue is therefore needed between the ECB and the governments of the euro countries. The arrangements are not yet clear but an intense discussion of this and other matters is now under way in Europe. The Treaty provides a number of opportunities for contacts between the two spheres.

Functional economic structures must also be in place so that the single monetary policy can establish low inflation without eliciting unnecessary economic tensions. A matter of particular importance in this context is the workings of the labour market. A labour market that functions properly reduces the risk of regional unemployment and thereby of political problems that could ultimately pose a threat to the monetary union.

Temporary factors

The discussion of the euro's development has included the point that the introduction of the single currency will trigger widespread portfolio rearrangements, mainly by private investors but also in public reserves.

The euro will alter the composition of exchange risks in investors' portfolios and this could result in flows to restore the degree of diversification. Investors who achieved diversification previously with holdings in German marks and Italian lire, for example, will have to adjust their portfolios when both these currencies are replaced by euro.

Demand for euro may also be affected by the single currency's conceivable international importance, so that the use of euro exceeds what one would expect from the area's economic weight. To achieve international status, a currency needs to be stable, liquid and large. It should be born in mind that the German mark is currently an international currency. So perhaps the changeover to the euro will not make such a notable difference even if a potential exists for the position of the euro becoming even stronger.

It is generally assumed that exchange rates will not be permanently affected by portfolio rearrangements which do not stem from more fundamental considerations. But as the euro's entry into currency markets is something entirely new, it is hard to tell whether the scale of portfolio changes will be such that euro exchange rates are influenced at least for a time. And as the rearrangements will probably include both investment and borrowing in euro, neither is it clear what their net effect might be. As I mentioned earlier, the development of the euro will ultimately depend on expectations of inflation in the euro area relative to the rest of the world.

3. Role of the euro in Sweden

How will the euro affect Sweden's currency, the krona? On the basis of theoretical analyses of what ought to determine a country's use of a currency, together with information the Riksbank has obtained from interviews and surveys of Swedish firms and households, we have concluded that the introduction of the euro will not appreciably alter the role of the krona in the Swedish economy.

The krona has important functions in Sweden's economy, both as a means of payment and as a unit of account and a repository of value.

The krona is already exposed to competition from other currencies. EMU can be seen as a continuation of this process. One indication of the competition is the very sharp increase in exchange market turnover. Since 1986 this turnover has grown by a factor of eight, whereas foreign trade and GDP have no more than doubled. Only 5 per cent of the exchange market turnover stems from transactions directly connected with foreign trade.

In what respects, then, might the advent of the euro alter the position of the krona? What is the line of reasoning behind such a scenario?

The discussion about a marginalisation of the krona has started from the view that Swedish export companies will choose to switch to euro in order to reduce the competitive disadvantage of being outside the euro area. With this area as an important field for trade, Swedish firms have to meet the increased price competition which the monetary union entails without reaping the benefits which their euro area competitors reap from decreased exchange costs and access to a large, liquid market for capital. In order to reduce these disadvantages, firms can try to match their euro income with their expenditures in Sweden, for example for wages costs and payments to suppliers. The exchange risk would then be passed on to domestic players—households and firms—and these in turn would want to pay their bills in euro.

How probable is such a scenario? One question is how serious the competitive disadvantages will actually be for export companies. Another aspect that can be discussed is the extent to which households and Swedish-owned companies are prepared to accept an exchange risk. They will want to receive income in the same currency as their expenditures. Otherwise they take an exchange risk that makes the real income uncertain.

Even when the monetary union has started, most of the expenditures of households and Swedish-owned companies will presumably be expressed in the national currency. Retailers set prices and accept payments in Swedish kronor. The status of the krona as legal tender means that they are under no obligation to accept payments in other currencies. Moreover, Swedish taxes and households' fixed long-term loans are paid in kronor.

Besides the question of why export companies would want to switch to euro on a large scale, it is thus not clear that they would be able to pass the exchange risks on to households and suppliers.

Large Swedish companies might be interested, on the other hand, in changing over to the euro as their unit of account, including the denomination of equity capital. Some business representatives have made statements to this effect. By reporting equity, deciding dividends and having their shares quoted in euro, companies with transactions in euro might possibly improve their access to the euro capital market and reduce their costs for handling currencies in the management of liquidity. Swedish law does not currently permit the use of currencies other than the krona but the possibility of having other currencies as the unit of account is being investigated.

Today, many companies invest their surplus liquidity in Swedish kronor, partly because their dividends are paid out in kronor. If companies choose the euro as the unit of account, this could have consequences for their asset management. One such consequence might be a preference for investing surplus liquidity in euro. This alters their investment portfolio, which brings us back to what I said earlier about short-run exchange rate movements. Presumably, however, the portfolio adjustments would be gradual, leaving the krona's exchange rate more or less unaffected by the flows. And even if the flows were to be so large as to influence the krona's rate, there is no reason to suppose that they would have a permanent effect on the krona's exchange rate against the euro. These flows would be accompanied by many other types of currency transaction.

The krona's long-term level will depend instead on Sweden's economic policy. When economic policy is credible and focused on low inflation, there are no grounds for believing that the krona would go on weakening continuously or that it would relinquish its position in Sweden's economy.

4. Concluding remarks

To round off what I have been saying, the development of a currency—be it the euro relative to the US dollar or the Swedish krona relative to the euro, for example—is dependent on the direction and results of economic policy. If the policies in the countries and regions we have been discussing are credible, focused on low inflation and successful, in the longer run the exchange rates ought not to diverge.

The legal framework for economic policy in EMU provides a good foundation for a credible low-inflation policy. But it is still important that all the components of economic policy back up the objective of price stability right from the introduction of the single currency. The ECB can do this by conducting a credible monetary policy and explaining it clearly. The national governments can contribute by ensuring that combined fiscal policies in the euro area comfortably comply with the Stability and Growth Pact; this is not yet the case. Measures that improve labour markets can also help to enhance conditions for the success of the monetary union.

In the same way, the institutional changes and economic developments in Sweden in recent years herald good conditions for a stable krona. The framework for both monetary and exchange rate policy has been strengthened. The status of the Riksbank is being made more independent and the budget process is now considerably more disciplined. Certain flows in the currency market may be generated simply as a consequence of the new currency's introduction but what ultimately matters is the economic fundamentals. This suggests that the advent of the single currency—the euro—will not lead to any marked changes either in the krona's role in the Swedish community or in its value.