

Speech

Second Deputy Governor Eva Srejber

WEDNESDAY, 21 APRIL 1999

How can Sweden best prepare for the EMU?

Finansforum

From my point of view, the short answer to the question posed by the organisers of today's discussion would be as follows: in the first place by keeping the economy in good shape and secondly, by maintaining a high level of preparedness to make it legally and practically possible to change the monetary unit in Sweden. I would like to expand on this answer, but I want to begin by underlining that there is, of course, a big difference between these two kinds of conditions; the requirement for good order in the economy applies regardless of whether Sweden participates in the EMU or not, while the other preparations depend on the timetable that will apply for a possible future Swedish entry into the EMU. Today, we cannot say anything definite about this timetable.

Future political discussion on Sweden and the EMU will undoubtedly be affected by developments in the other EU Member States that are now outside the monetary union. The direct influence on Swedish public opinion of Greek entry into the EMU is perhaps not so great. However, Greece may be the first in line for an expansion of the monetary union as they are aiming at taking part from 1 January 2001. Closer to home, it can be noted that various opinion surveys from Denmark

SVERIGES RIKSBANK

Telefon
08-787 00 00

Telefax
08 - 21 05 31

E-post
registratorn@riksbank.se

have indicated for some months that a shift has taken place in favour of reconsidering the Danish derogation. In the United Kingdom, the Government has taken a clearer position and has even put forward a changeover plan for the introduction of the euro, although without defining a date for when it can be set into operation.

It is not my role to assess the political developments, but I wish to draw attention to what is happening in other countries and to point out that this issue can rapidly become a burning one also in Sweden. Having said that, let me pass quickly on to give my view on the prospects for Sweden.

When the preparations for the EMU started, there was a clear focus on the entry conditions laid down by the Treaty on macroeconomic stability for a country to be allowed to participate in the monetary union. However, the public debate about this process often lost sight of the underlying idea that healthy public finances and stable prices are a prerequisite for sustainable economic growth. Instead, it was often argued that it was the EMU's "fault" that public allowances had to be cut and taxes increased, in order to comply with the 3 per cent deficit limit for public finances. When the Stability and Growth Pact was subsequently adopted, it became clearer to everyone that it was not sufficient to have good order in public finances at a particular moment in time, but that this was a permanent requirement. Indeed, the most important part of the pact is not the prohibition, in principle, against exceeding the 3 per cent limit in a particular year, but the requirement that public finances are to be in balance or exhibit a surplus in the medium term. If the development of public debt can be kept under control more permanently, it also reinforces the credibility of monetary policy being able to produce price stability at low interest rates. The full potential for balanced economic growth can then be further developed if macroeconomic stability is supplemented by reforms that improve the functioning of the European economies. The rules of the Stability Pact apply therefore to all EU Member States, those participating in the EMU as well as those outside.

The requirement of the Stability Pact for balance or surplus over a business cycle also has another merit, namely that it gives individual countries room to allow the automatic stabilisers to operate in order to counteract normal cyclical downturns. To be able to make use of this, Member States must ensure that they establish a good foundation during conditions of healthy growth. Despite reasonable economic growth in recent years, the deficits in a number of EU Member States have remained disturbingly large, which makes them more vulnerable. It might then become necessary to tighten fiscal policy in a situation where growth is slackening, which entails both political and social costs. In a number of countries, efforts must, therefore, be intensified to consolidate public finances.

However, it must be said that this is not at present in the first place applicable to Sweden. The objective laid down by the Swedish Government of a budget surplus of 2 per cent of GDP in the medium term is among the more ambitious within the EU. It also enjoys credibility as there is now in fact a surplus. In the financial markets, there is, however, always some uncertainty about the future direction of the political

decision-making process and whether this objective will be sustained in the long-term. Sweden's history of sound central government finances is, after all, not so long, and it is difficult to judge whether the Swedish central government budget will be less cyclically sensitive than in the past. Adequate margins of safety are therefore valuable, especially in view of the high central government debt. The large size of the public sector in Sweden can also make future pension and health expenditure more difficult to deal with than in many other countries. Even though the demographic development in Sweden is rather less unfavourable than in other countries, we have, therefore, still a larger initial "burden of proof".

The objective of fiscal policy is thus the same regardless of whether Sweden participates in the monetary union or not. The same applies to monetary policy which has in both cases price stability in the medium term as its overall objective. The European Central Bank (ECB) has adopted a slightly different concept to the Riksbank for its quantification of what is meant by price stability, but the objectives are in substance the same. While the Riksbank endeavours to restrict the increase in the consumer price index to 2 per cent per year, the ECB uses the harmonised consumer price index HICP for the euro area as a base, and states as its objective that the annual rate of increase shall remain below 2 per cent. Although the ECB has not specified any lower limit for the rate of price increases, the intention is that it shall be positive, i.e. that deflation or falling consumer prices are to be avoided. Looking at the historical development of the two index series HICP and CPI in Sweden, it can be seen that the annual discrepancies are small and that there is no systematic long-run difference. The Riksbank is studying these technicalities carefully and may consider changing over to HICP once the Swedish CPI report is finalised and when the concept of HICP has been further developed in the EU, which is not yet the case.

The level of the Riksbank's objective is thus compatible with the top of the price range specified by the ECB. Whether systematic differences will arise in the future will depend primarily on the approach adopted by the ECB in practice and on where the expectations of the rate of price increases in the euro area will in fact settle. If it proves to be the case that the ECB aims at keeping inflation well below 2 per cent per year, the Riksbank must probably take this into consideration in its future monetary policy. And if Sweden joins the monetary union, we will, of course, be subject to the ECB objective, although I do not then foresee any crucial difference with respect to monetary policy.

However, the fact that the objectives for monetary policy in Sweden and the euro area are equivalent naturally does not mean that the monetary policy stance must be identical at all times, as long as Sweden remains outside the monetary union. The ECB is responsible for price stability in the euro area as a whole, the Riksbank for stability in Sweden. Depending on differences in the cyclical situation and other factors of importance for inflationary pressure, there may be differences in both the level and interest rates. This was illustrated at the end of March when the Riksbank reduced the repo rate to 2.9 per cent while the ECB stayed at 3.0 per cent, and when the ECB later reduced to 2.5 per cent, the Riksbank did not follow suit. The Riksbank makes its decisions independently and does not need to consult the ECB

about them; the consultation mechanism that exists between the ECB and the non-participating national central banks is focused on the long-term goals and assessments of the policy implications thereof in general. However, the need for cyclical reasons to be able to carry out a different monetary policy in Sweden should not be exaggerated, since we are not fundamentally out of phase with the cyclical development in the euro area today. On those occasions in the past when we have had a divergent economic development in Sweden, it has to a large extent been due to what now often appears to be economic policy mistakes of our own making rather than fundamental differences in the economic structure compared with most other European countries.

Even though similar requirements are placed on economic policy regardless of whether Sweden takes part in the EMU or not, the Riksbank considers that participation would confer added benefit on Sweden. The Riksbank developed this point of view in its comment on the so-called Calmfors report in spring 1997. The Riksbank takes the view that there are advantages primarily related to welfare gains and increased Swedish influence on developments in the EU. To "wait and see" does not reduce the requirements on stabilisation policy and the need for structural reforms.

If Sweden applies for participation in the monetary union, the European Commission and the ECB shall examine the extent to which we fulfil the Treaty's convergence criteria before the final decision, which will be taken at the highest political level, by the EU Heads of State or Government. If the development and approach of the economic policy that I have just described persists, there is no reason to fear that the outcome of this examination will be negative for Sweden. As regards the situation for public finances or convergence in the rate of inflation and long interest rates, we clearly meet the criteria at present. The final criterion, relating to exchange rate stability, was referred to a year ago as the foremost formal motivation for deciding that Sweden did not fulfil the necessary conditions to take part in the monetary union from the start. However, the Treaty is not particularly easy to interpret on this point. The motivation that was formulated on the exchange rate criterion in spring 1998 is characterised in EU fashion by a "constructive ambiguity", that leaves several options open for the future. A year ago, Member States that had not taken part in the exchange rate mechanism for two years were approved as participants in the monetary union, and currencies with greater volatility than the Swedish krona were accepted. Moreover, the ERM has since then been replaced by ERM2, which is designed in a different way than the multilateral grid of central rates in the old ERM and of which no mention whatsoever is made in the Treaty.

Thus, the decision on whether a Member State is qualified to participate in the monetary union is the result of political evaluations. The contribution of the central banks to this decision consists of providing a background analysis of the factual development. Without involving myself in the political deliberations that must ultimately take place, I dare hope that if there is a political will in Sweden to take part in the monetary union, if economic policy continues to be focused on

stability and if the krona's exchange rate to the euro is at a reasonable level, the other EU Member States will also want us to join.

Let me then mention a few things about the more practical aspects of the preparations for Sweden joining the euro area. In the Riksdag decision from November 1997, it was said that the door should be kept open for a Swedish entry into the EMU at a later stage. The greatest possible freedom of action was to be maintained on the basis of a sustained position of economic strength. The Government Offices have an organisation to monitor how preparedness is sustained in different parts of society. The Riksbank's own preparedness is such that we consider that at most a year will be required from the Riksdag taking a possible decision on Swedish participation until we have the necessary functions in place to be able to take part in the single monetary policy and other parts of central bank co-operation. However, this will require some additional adjustments of legislation beyond our control. One of the more time-consuming preparations concerns the capacity to produce euro banknotes and coins with the requisite high security standards; the Riksbank has, therefore, participated in the development work initiated by the ECB and has, among other things, carried out test printing of banknotes on a limited scale. Furthermore, the Riksbank has a special responsibility for co-ordinating EMU preparations in the financial sector, and in a number of reports in recent years we have given an account of the consequences of the introduction of the euro for Sweden outside the monetary union, and we have started to make an inventory of the changes that would be required if we were to take full part.

As I noted to begin with, the preparatory work is taking place, with respect to necessary changes in different sectors in Sweden, in conditions of great uncertainty as to the timetable for a possible Swedish participation in the monetary union. This is an unavoidable cost if we are to live up to the Riksdag's decision on freedom of action. The Riksbank's ambition of a one-year period of preparation needs to be viewed in relation to the political process. Without being unduly speculative I believe that a hypothetical scenario can be developed on the basis of the signals that have emerged to date. Assuming that there will be an extra social-democratic party congress in about a year's time, and taking into account the further time that will then be needed to obtain broad political support and to complete the political and legal preparations of the issue within Sweden and the EU, I believe that Swedish participation from 1 January 2002 is a possibility. But it may, of course, be later – or perhaps not at all for the foreseeable future. At all events, 1 January 2002 is the date when the eleven countries in the first EMU wave take the final step in the changeover process and replace their banknotes and coins in the respective national currencies with notes and coins in euro.

Swedish financial companies and institutions have to date carried out a considerable amount of work to adapt to the introduction of the euro. This has meant that a number of financial services and payment transmission services are now available in euro on the Swedish market as well. However, the euro is, of course, still a foreign currency for Swedish agents, and the new processing procedures have been introduced in parallel with those for other foreign currencies.

It will be necessary for some time to come to continue to deal with the eleven national monetary units that have been subsumed in the euro, even though they have disappeared from some types of transactions. Each financial company decides according to commercial considerations what types of services it wishes to offer its customers. On the other hand, entry into the monetary union would mean a wholly different organisational environment for financial companies, both since the exchange rate between the krona and the euro would then be irrevocably fixed and since there would be a time plan for replacing the krona by the euro in legal and practical terms. It would then be possible to take investment decisions for systems and strategies with a considerably higher degree of reliability than before. It is not possible to say for certain today whether Sweden would also be able to replace notes and coins at the same time and thus carry out the entire monetary reform as a 'big bang', but that much can be said that the administrative consequences in such a case would be considerably more extensive as they would affect the entire cash handling system in Sweden.

To sum up: The best way for Sweden to prepare for the EMU is to ensure sound government finances, good price stability and structural reforms. In fact, this is also a good way of preparing for life outside the EMU, but participation in the monetary union can increase the return on such a policy. The greatest possible freedom of action ahead of a political decision on the EMU issue also requires that we keep up with practical preparations for the introduction of the euro.