Speech

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The euro and European economic policy

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The single European currency, introduced at the beginning of this year, marks a major change for the economic policies of countries in the euro area. The clearest example is, of course, the transition to a single monetary policy. The proper functioning of the monetary union in the long term presupposes that the new European Central Bank succeeds in making its policy and the euro understood and credible. Important factors in this context are how the new central bank chooses to work, how monetary policy is continuously formed and how it is communicated to the general public and to markets.

However, a well-constructed monetary policy and a central bank that acts wisely are not sufficient to ensure that the union functions in the longer run. If growth and employment in the euro area are to be as high as possible without jeopardising price stability, all the components of national economic policies will have to pull together. The fiscal, structural and labour market policies of the individual countries influence both the conditions under which the new central bank is operating and, to the highest degree, Europe's future prosperity.

A framework exists for this joint effort. Some common rules, for example the Stability and Growth Pact, have been constructed to ensure that national fiscal policies do not pose problems for the union as a whole. There is also a continuous discussion of economic policy in various fora, of which the foremost are the Ecofin Council, made up of the ministers of finance and economy, and its subordinate committee, the Economic and Financial Committee, which also includes

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representatives of the national central banks. The euro countries' ministers of finance and economy also meet in what is know as the Euro 11 Council.

This framework has been finalised in principle but is being reassessed continuously in the light of new challenges. Economic activity in the euro area this spring has been weaker than anticipated and this has been accompanied by growing disparities between national growth rates, budget balances and inflation. As a result, a number of central questions about how the monetary union functions have quickly come to the fore in the member states' discussions.

Although Sweden is not participating in the euro area, developments there will affect us. This is a large currency area in our immediate vicinity with which we have widespread trading relationships. As a member of the European Union, moreover, we have to observe many of the established rules and guidelines; we also participate in the European discussion on the formation of economic policy. Against this background, my talk today concerns economic policy in Europe and the new conditions that accompany the euro.

The single monetary policy

Basic features

The European Central Bank (ECB) has been responsible since the beginning of this year for the single monetary policy in the euro area, with the primary objective of maintaining price stability. The general formulation of this objective has been defined more precisely by the ECB as being a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent. In that this definition refers to the rate of increase, it means that deflation is excluded in practice and the annual rate of change in the HICP should accordingly be between 0 and 2 per cent.

The single monetary policy is based on assessments of a wide range of economic and financial indicators of inflationary pressure. A prominent position is likely to be accorded to the money supply. As a reference value for annual monetary growth, the ECB has initially set a rate of 4½ per cent. The combined strategy—focusing on inflation but with a reference value for monetary growth—is motivated by the great uncertainty as to how the aggregate euro economy will function initially. The ECB therefore wants to avoid having to stand on only one leg in its assessments.

The ECB also states that the objective is to be fulfilled over the medium term and thereby underscores that the single monetary policy is not to parry every short-term shock. Deviations from the target may be acceptable during a relatively short period.

An analysis of the economic situation is published by the ECB in a monthly bulletin, which aims to 'explain to the public the monetary policy decisions taken by the Governing Council of the ECB'. The bulletin will also consider fiscal policies, economic structures and labour market tendencies in the euro area. But the ECB does not publish either forward-looking assessments and forecasts of inflation or the minutes of decision-making meetings and the positions of individual members. Press conferences with the ECB Executive will be held, however, in connection with meetings of the Governing Council. In addition, policy will be explained continuously by Executive Board members in speeches and appearances before the European Parliament.

Inflation assessment

The ECB and the Riksbank both have *price stability* as the monetary policy objective but they have given this objective different operational definitions. The ECB's formulation mirrors a different view of monetary policy's ability to fulfil an explicit target. Presumably it also reflects a different view of the margin a central bank shall have for tolerable deviations from the desired price stability. The Riksbank has specifically targeted inflation, measured by the CPI, at a rate of 2 per cent, with a declared tolerance interval of ±1 percentage point, thereby clearly identifying the preferred level of inflation.

It is still too early to say what the differences between the formulations will signify in reality, just because we do not yet know how the ECB will act in practice. The conduct of monetary policy in Sweden is also being developed and specified in the light of new experiences. Moreover, the ECB's target is formulated in such a way that the level of ambition can be varied. It is perfectly possible, for example, to strive for inflation around 1 per cent when inflation in the rest of the world is low and to accept a higher rate when the external situation is less favourable. Historically, inflation in Germany over the past two decades has averaged 2 to 2.5 per cent and the rate in the European Union in the 1990s has averaged 3.4 per cent, as against an average of 3.7 per cent in Sweden.

A common feature of the two monetary policy strategies is their focus on the *medium term*. The Riksbank has expressed this in such statements as that policy is to be assessed in an annual perspective and that its full impact occurs after twelve to twenty-four months. Moreover, the Riksbank has clarified how transitory effects on inflation are to be treated. A deviation from the inflation target on a single occasion will not lead either the Riksbank or the ECB to adjust interest rates abruptly in order to achieve a rapid return to the target. Adjustments are to be gradual, which implies smaller fluctuations in the interest rate and thereby also in production and employment.

Communication and evaluation

So far the ECB has chosen not to publish the assessment of inflation on which the single monetary policy is founded. This has been justified by saying that it might cause more confusion than clarity about the grounds for the policy. That has not been the Riksbank's experience. Our view of inflationary pressure in the Swedish economy is published on a quarterly basis. The clear presentation gives observers a chance of understanding and questioning our assessments. As new information becomes available, moreover, they are in a position to relate it to our earlier assessment and continuously form a fairly good picture of how interest rates are likely to move in the future.

The publication of our inflation assessments has also facilitated decisions in recent years to raise or lower interest rates. In that the grounds for our actions are clearer, there is less risk of our being accused of heeding extraneous considerations, a worry that featured in the European discussion last autumn. It is my belief, however, that the ECB will become more open about its economic assessments as it settles more comfortably into its forecasting process and inflation assessment.

Another difference in transparency concerns *access to discussions* at the decision-making meetings. The ECB has chosen not to publish any minutes. An important argument for this policy - and one that I find understandable but debatable - is that minutes disclosing how individual members voted might occasion a greater element of national considerations. The Riksbank has chosen to publish minutes of Executive Board meetings after an interval of 6–8 weeks; the minutes are to reflect the discussion and indicate how the members voted.

The clearly independent status that has now been assigned to the Riksbank has much to do with this choice. The minutes make it easier for policy evaluators to follow the formation of monetary policy and assess the actions of Board members. This is a democratic interest. Moreover, the fact that the voting will be published probably increases the members' motivation to form a personal opinion about the difficult matters that have to be considered. I also believe that access to the minutes can help people to understand the choices that have to be made in the formulation of monetary policy and demystify what the Riksbank is doing. It is arguments of this type that made my British colleague Mervyn King declare, with reference to the work of the Bank of England's Monetary Policy Committee, that 'Divided we stand, united we fall'.

I want to emphasise that these matters are by no means simple. It seems to me that a clear analytical framework, combined with a high degree of transparency, has provided a good foundation for Swedish monetary policy in recent years. But with an Executive Board consisting of six members, each of whom is in a position to voice an opinion on monetary policy, it is probable that from time to time the Riksbank will be criticised for being indistinct. There were signs of that last week when the minutes from April showed that I had not voted with the Board's majority. But as observers and market players become more accustomed to how we operate, such differences of opinion are likely to attract less attention.

Still, monetary policy signalling clearly cannot be arranged in quite the same way as before and in this respect we will presumably become more like the ECB and the Bundesbank, where individual statements do not automatically constitute a collective signal from the central bank. For those who are interested in following us and our assessments, however, we strive to provide a good foundation by publishing—at intervals of approximately six weeks—either an Inflation Report or a lengthy press notice on the majority view of inflation prospects.

Fiscal policies in the euro area

Let me now turn to the conduct of fiscal policy in the euro area. A judicious monetary policy is not sufficient to ensure that the monetary union functions properly. The single currency will make the national economies more interconnected than before. The formation of fiscal policy in one country will affect the overall picture of economic prospects and thereby monetary policy. In the Maastricht Treaty the countries accordingly agreed on certain common rules for economic policy and these have been fleshed out with additional legislation and political agreements.

Besides fixed and binding undertakings for each country, there are regular common processes for producing more general guidelines and standards for economic policy. The national convergence or stability programmes each member state presents to show how it intends to follow the guidelines supplement the latter, which can be likened to a common budget statement for the euro area. It is envisaged that the countries will exert peer pressure to bring about a good economic development in each country and thereby fulfil the common objectives of sustainable growth with high employment and stable prices.

A central issue here is the formation of fiscal policy, for which there are binding rules. In the Maastricht Treaty the EU countries agreed that budget deficits and government debt relative to GDP are to be limited to 3 and 60 per cent, respectively. In summer 1997 the EU finance ministers agreed to clarify and tighten the existing fiscal policy goals so as to guarantee a sound development of government finances in the Union. The background to this was that the rules of the game once the monetary union had been established were less clear than the criteria for participation in the euro area. More specifically, there were worries that once they had joined the euro area, countries with a high debt ratio would implement a less vigorous policy because their incentives for exercising restraint would not be as clear. The pressure on these countries to consolidate their budgets might also ease if their interest rates fell on account of 'borrowed' credibility from the German economy.

The Stability and Growth Pact was initiated by Germany. It means that all EU countries—and thus non-euro countries such as Sweden—are bound by the rules for fiscal policy and its surveillance after the move to Stage Three. Each country is to strive for budgetary positions close to balance or in surplus in the medium term. This is intended to allow the automatic stabilisers free play while keeping the government deficit inside the 3 per cent limit. In this way the Pact provides for some flexibility in fiscal policy, which may be particularly important when there is no recourse to exchange rate adjustments.

If the budget deficit exceeds the 3 per cent limit, sanctions can ultimately be imposed on the country in question if the problems are not tackled. It is only in exceptional circumstances that this may not apply. A surveillance procedure has been established for monitoring developments; national stability programmes are to be presented at regular intervals, showing how the goals are to be fulfilled. This process is perhaps as important in practice as the threat of sanctions. The establishment of clear rules and sanctions is intended to support the forces in each country that favour a disciplined fiscal policy. The sanctions do not apply to non-euro countries and they submit convergence programmes instead of stability programmes.

So what has happened so far? The assessment of convergence or stability programmes from all the EU countries this spring shows a mixed picture. It is clear, however, that the ambitions of most countries still fall short of the requirements in the Stability and Growth Pact. This is certainly attributable in part to the economic slowdown, with Italy as the clearest example. But it is also notable that the ambitions for budget consolidation are now lower than before the move to Stage Three. The relatively good growth during 1998 ought to have left room for budget consolidation in many countries but it was not used and in certain countries the structural deficit has actually increased. The Ecofin Council has in fact criticised a number of countries, including Germany, France, Austria and the Netherlands, for the low level of ambitions in their stability programmes.

In Sweden, the budget position looks comparatively healthy. Our fiscal policy is likewise less restrictive than before but the structural deficit has been turned into a surplus that is now growing and the ambition is still to achieve a budget surplus of 2 per cent of GDP on average over the business cycle.

At the same time it should be underscored that some variation in the objective across countries seems reasonable. The degree of fiscal readiness—and thus the requisite size of the surplus—depends on a number of factors. One is the cyclical sensitivity of government finances and another is the level of government debt. It is then reasonable that a country like Sweden has a larger public sector financial surplus than a country where the automatic stabilisers and government debt are smaller. But it is also important to maintain the peer pressure that has been used to ensure that the member states observe the common rules. Arguing the case for adhering to these rules in a country’s internal debate is difficult if other member states lower their ambitions.

Policy interaction

Economic policy in the euro area is accordingly formed in the interaction of the single monetary policy and what are primarily national fiscal and structural policies. If this interaction is to function properly, much is required of the parties involved in the way of clarity and a dialogue.

The available structure for coordinating economic policies in the European Union consists of a network of different bodies and reports, with the ultimate purpose of arriving at a shared picture of the framework for economic policy. The forms for cooperation are being developed all the time and a number of new instruments have been introduced in recent years.

A schedule has been established for the continuous exchange of information and views during the year between the member states, the Commission and other Community bodies, including the ECB. Reports on compliance with the guidelines for fiscal policy, employment and structural policy are submitted by each country for discussion and examination by the other member states, the Commission and the ECB. The ministers in the individual countries finally adopt the programmes, which then form the basis for the next discussion of the general economic policy guidelines, which are adopted each summer by the heads of state or of government. In between, each country is analysed by the Commission, which is required to give early warning if countries do not fulfil undertakings they have made in their national programmes.

The idea behind this structure is the principle of subsidiarity, that is, matters to be decided jointly by the member states are to be limited to those for which a decision at this level is absolutely necessary; everything else is a national concern.

The ECB is to guarantee price stability. Monetary policy has to be formed in the light of fiscal policy's expected development. Similarly, inflation has to be assessed in the light of the existing trade policies and the prevailing structures in labour markets, agriculture and so on. There is no question of coordinating policy in the sense of the ECB undertaking to act in a certain way if policy in other fields is adjusted or realigned—what euro jargon refers to as ex ante coordination. This naturally accentuates the need for clarity in monetary policy. It is reasonable that politicians in Europe are enabled to assess what an adjustment of fiscal policy, for example, would have for consequences for the interest rate.

Against this background I now want to consider three issues to do with European economic policy that in my opinion have been illustrated by developments in the past six months and should be discussed in the European economic policy debate. All these issues concern the need to develop the institutional framework so that it covers coordination problems that may arise even though the rules are being followed.

Firstly, monetary policy is naturally not fully attuned to every euro country at present. Cyclical activity as well as other factors that affect inflation vary over the euro area and as I mentioned earlier, these differences have become somewhat larger. By itself, this need not be a major problem for the monetary union as a whole. The differences may reflect entirely natural deviations in productivity growth, for instance. In that cases the differences in inflation need not be all that important in the longer run.

The differences in inflation are more of a problem if they derive from differences in the development of demand. But even in this case it can be argued that they will mainly lead to problems for the particular country where inflation is higher; rising costs ultimately result in downward adjustments of production, employment and inflation. There may be uncertainty, however, about the smoothness of such an adjustment and its consequences for the union as a whole. Even if the development of inflation in one country may conceivably disturb the path for the union, that country cannot be required to tighten its fiscal policy as long as it complies with the Stability and Growth Pact.

Secondly, at present there is thus no mechanism whereby a fiscal adjustment could be spread over the participating countries. This is also a problem because the implementation of the Pact indicates that there is a risk of this contributing to a procyclical budget policy. To date, the Pact's surveillance process has focused on countries with a budget deficit close to the limit. There is nothing remarkable about that: this is where the problems are most apparent and the risk of failure—with problems for the credibility of the Pact as a whole—is most acute. But there is also the risk of the Pact having a procyclical effect. Countries that are close to the maximum deficit on account of weak activity are obliged to follow a restrictive line, while those with good activity and a surplus do not need to tighten their policies in this way.

This problem has arisen because the Pact was actually constructed so that it only functions properly when all the member states have established the necessary margins. That is still not the case. For the euro area as a whole it would presumably be best in the present situation if the countries with high activity were to tighten their policies even more. That might create room for a somewhat lower interest rate in this area in the coming years and thereby ease the situation for the consolidation of government finances in the countries with the greatest problems. At present, however, there are no mechanisms for bringing such a policy about.

Thirdly, even if the fiscal position in all the countries in question were now in good order, the trade-off between fiscal and monetary policy raises issues for which there are still no ready-made solutions. Let us take the hypothetical case of a falling stock market in the United States that pulls the dollar down. The recent trend would then be reversed into an appreciation of the euro. That would be liable to check the recovery of manufacturing in the euro area. What should the EU finance ministers do? One possibility would be to go for an overall tightening of fiscal policy in order to pave the way for lower interest rates and a weaker euro. As things stand, however, it is not clear how this could be done in practice. Once again we face the question of the restriction's distribution among the participating countries.

These three interrelated issues are all important. The solutions are hardly self-evident, partly because they involve the difficult balance between national concerns and matters that should be decided at union level.

Conclusion

The euro's introduction in eleven countries in our part of the world is the biggest economic policy change in Europe for decades. New conditions have been created not only for households and firms in the euro area and adjacent countries but also for economic policy.

Sweden is by no means unaffected by this change, even though we are outside the euro area at the start. Economic development in the euro area is crucial for Sweden's economy. As a member of the European Union, moreover, we are involved in many of the contexts where policy is formed. We have also undertaken to conduct our policy in accordance with the rules that have been established for the union.

Against this background it is important that we are engaged in the discussion of economic policy in Europe. My purpose today has been to highlight a number of issues of importance for the European debate. I have tried to describe how the ECB works, the rules that have been built up for fiscal policy and so on. I have also said something about events in the past six months and discussed some of the problems as I see them.

One thing is certain: the euro's introduction does not constitute the final step in the integration of Europe. The single currency will raise new questions that will be answered by degrees through the cooperation between the countries of Europe. It is important that Sweden takes an active part in that debate.