Kristina Persson: The impact of the euro

Speech by Ms Kristina Persson, Deputy Governor of Sveriges Riksbank, at the Women's Economic Round Table, New York, 29 October 2003.

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Allow me first to extend special thanks for this invitation. It is particularly important for me personally as well as for the Riksbank to be given this opportunity to meet women economists and discuss current economic issues. I am privileged to be one of three women on the Riksbank's Executive Board, which has a total of six members. At the Riksbank we strive to attain an even distribution of men and women at all levels. This is a deliberate policy but also reflects the sharp rise in the proportion of women among qualified economists entering the Swedish business sector in recent decades. If this trend is to continue, and more women are to take the chance of achieving success in this traditionally male profession, we will need more role models like you here today.

The subject of my speech is "The impact of the euro", a topic that was decided before 14 September 2003, when Sweden held a referendum on introducing the single currency. Personally I am convinced for many reasons that Sweden should introduce the euro, and made no secret of that. However, as many of you know, the result was a clear 'no' to the euro.

The question of the economic advantages and disadvantages of the euro often resembles a tug-of-war between the short- and long-term perspectives. The risks, when highlighted, often temporarily overshadow the long-term gains, which arise in small incremental doses over a long period.

Unfortunately, short-term conditions came sharply into focus just when the Swedish people were about to vote, as attention was turned to the global economic slowdown and its effect on the euro area, particularly in the major countries. GDP growth in Germany and France is forecast to decline from 0.2 per cent and 1.3 per cent respectively in 2002 to 0.0 and 0.3 per cent in 2003 (Riksbank forecast). This is the poorest rate of growth in these countries in over a decade. In the debate on the euro, this contraction in growth was largely attributed to the limitations imposed on these countries' economic policies, as they did not have a national monetary policy, and to the fiscal policy constraints of the Stability and Growth Pact. As we know, the budget deficits of both Germany and France have in both 2002 and 2003 exceeded the reference value of 3 per cent of GDP, which was established in the EU's Stability and Growth Pact. At the same time, attention in the debate was drawn to the temporary and one-off rise in prices of certain goods that occurred when prices were rounded after the introduction of the euro.

In light of this, it is understandable that many voters got the impression that there were no economic benefits of participation in the euro. Furthermore, those that voted against the single currency may have been strengthened in their belief by the fact that the 'no' vote was not followed by any speculation against the krona, which instead has appreciated against both the euro and the dollar since the referendum.

What didn't feature in the same way in the debate was the longer-term perspective - and it is this perspective that I believe speaks in favour of the euro. It proved difficult to explain that the underlying causes of the crisis in Germany and France were mainly domestic structural problems, partly in the labour market. Those problems had existed long before EMU and could not be remedied by a separate currency and monetary policy. At the same time, the economic slowdown overshadowed the long-term transaction gains of a single currency for trade and the financial markets.

In earlier economic research, the gains associated with a single currency were often viewed as uncertain and very small at best. As there were very few contemporary examples of currency unions, comparisons were made instead between fixed and floating exchange rates, in which fixed exchange rates did not appear to result in any definite welfare gains. More recent research has concentrated on the smaller currency unions that have nevertheless existed, and has excluded other factors in so-called gravitation models. This research has pointed to quite substantial gains from currency unions (a shift in the magnitude of 50 per cent or even more according to researchers such as Andrew K Rose, at Berkeley). Even conservative estimates indicate a considerable rise in trade within currency areas, and attendant welfare gains. Other studies, which are directly based on trade dynamics in the last decade, suggest that trade between the euro area countries may have increased by 5-10 per cent as a result of the euro.

Another long-term gain is in price competition. The limited and temporary rise in prices of certain goods and services in conjunction with the introduction of the euro notes and coins should be weighed against the long-term gains from price transparency, the effect of easier price comparisons when prices in the entire euro area are expressed in the same currency. Previously, this particular gain was also perceived as minimal as cross-border trade is relatively small and companies themselves are said to be capable of converting prices regularly between currencies without suffering any major efficiency losses. However, at the same time, there were price differences in the EU of 20-30 per cent on a number of goods (cars, for example) that should be relatively easy to both transport over the border and compare in terms of price. These differences appear to have diminished quicker since euro banknotes and coins were introduced in 2001. New research also suggests that the effects of a common currency on prices may have been underestimated. For instance, Charles Engel from the University of Wisconsin compared price differences for the same goods in cities on both sides of the Canadian and US border with price differences between different cities in the US. Although US and Canadian cities have largely the same language and culture, as well as free trade, the different currencies cause prices to vary as much on each side of the border as between cities at opposite ends of the US.

Finally, of course, there is the increasingly important role of the euro as a dominant international currency.

The most immediate gain from this is an increase in seignorage income to the extent that the euro is more widely held outside the euro area than the sum of the currencies that preceded it. Taken as a whole, the euro area is the world's largest exporter and importer, accounting for about one-fifth of international trade. Despite this the US dollar is still the most common counterparty in foreign exchange trading and the widespread use of the dollar as a 'vehicle currency' in itself reinforces its status. Given that the euro is still a young currency it is likely to grow in importance and may in time have the potential to catch up with the dollar's share in the foreign exchange markets. Furthermore, by replacing 12 currencies, in particular the German mark and the French franc, the euro was used immediately as a reserve currency by central banks and became part of a currency basket (for example in Morocco) or a solitary anchor for the exchange rate policy of some countries (like Estonia, Bosnia and Bulgaria). Nevertheless, two-thirds of world reserves are still held in US dollars compared with less than 15 per cent in euros, although since the euro's introduction there appears to have been a gradual shift in the composition of the reserves of large economies such as Russia, and even China, towards an increased share for the euro. All this points to larger income to the euro area from external holders of the euro, a small but not insignificant gain given that estimates of US seignorage income from external holders of the dollar is estimated at almost 1 per cent of GDP.

The euro is also bound to increase the efficiency of euro area financial markets. The use of the euro in the international debt market has increased compared with the joint share of its preceding currencies. The share of international bonds denominated in euros and issued by non-euro area residents has increased to about 30 per cent, compared with 20 per cent for the currencies that preceded the euro. Important factors behind this development are the larger home-currency investor base and the better issuing conditions for international borrowers provided by the unified European money market, which is now more liquid and efficient than the markets in the individual countries before the introduction of the euro.

Needless to say, European equity markets have also been affected by the disappearance of currency risk within the euro area. There appears to be a gradual shift from the domestic focus in the euro area countries to a euro area-wide, sector-related, view. Integration is likely to attract a broader range of potential investors and benefit the development of private equity and financing opportunities for new firms.

In addition to these economic advantages, we must naturally also include what I consider to be the decisive political arguments in favour of Sweden participating fully in the political and economic cooperation with a view to attaining a position of influence in a strong and prosperous Europe.

The fact that the Swedish krona has not been more negatively affected by the result of the referendum, despite the foregone advantages, could in turn be due to long-term factors that are independent of EMU. The political uncertainty ahead of the referendum should indeed have contributed to the somewhat weaker krona during the summer. However, the krona has been considered undervalued for a long time. So, one reason for the krona's current recovery is that the markets are once again focusing on Sweden's long-term, stable macroeconomic policy, which has remained in place regardless of EMU. This policy includes the Riksbank's inflation target and a budgetary framework that has the support of all parliamentary parties.

Thus, Sweden will remain outside the euro for the time being, together with its fellow EU countries Denmark and the UK. But as early as May next year the EU will have ten new Member States and around 100 million new inhabitants, the vast majority from Central and Eastern Europe. Of these ten, nine have expressed their desire to join monetary union as soon as they meet the convergence criteria. Contrary to many people's expectations, several of these countries appear fully capable of meeting the criteria in the next few years. After a decade of reforms leading from planned economy to market economy, inflation and budget deficits have been cut and debt levels have been kept in check in a number of the smaller countries, while for the bigger countries, such as Poland, Hungary and the Czech Republic, budget consolidation is their last remaining obstacle. So it is not unrealistic that a handful of new countries could introduce the euro as early as 2006-2007, or in any case 2-3 years later. It may be that Sweden, Denmark and the UK will have to discuss their future relationship to the euro at the same time as the euro area expands to include half a dozen new countries.

The Central and Eastern European countries will also have to weigh the long-term gains of adopting the euro against the risks of asymmetric shocks. The advantages for these countries are perhaps even clearer than for Sweden. Particularly substantial gains may arise from increased financial integration through the euro. Thanks to the fact that banks from EU countries have acquired large sections of the banking system in eastern Europe, the financial sector there has been able to evolve relatively quickly. But the new Member States' financial systems are still rather undeveloped, with credits in relation to GDP of between one-eighth and one-quarter of that in the euro area. Sweden's Baltic neighbour Estonia is one example of how currency integration can help the financial system to evolve. The Estonians have pegged their currency to the euro for over a decade and are keen to quickly take the step into monetary union. Their banking system is owned by Swedish-Nordic banks and credit volumes are growing by 20-30 per cent a year - most of which is denominated in euro. In some countries, the euro can also help to cement the macroeconomic discipline that is still a relatively new phenomenon there.

Meanwhile, the risks that stem from the countries possibly diverging from the euro area average are perhaps also clearer than for Sweden (which is a country that is unusually well-integrated with euro area countries and has a similar economic structure). But some factors suggest that the new Member States in central Europe do not need a different monetary policy than that of the euro area. These countries also have close ties with the rest of the EU, which is their biggest trading partner by far, accounting for some 50-70 per cent of imports and exports. Having said that, the countries are still undergoing a period of quick change; it is conceivable that any potential shocks during such a transitional period would be managed better through a national monetary policy. Their growth is and should be considerably higher than the EU average as long as they continue to reduce the differences in their standard of living compared with the rest of the EU. This always entails risks of overheating similar to that experienced by the fast-growing Irish economy.

The assessment of the risks related to the process of change and of the long-term gains varies between the different candidate countries depending on how open and flexible their economies are. Nevertheless, it seems that the advantages of integration will outweigh the disadvantages when the new countries have assessed the euro, even if it is likely that some of the new Member States will have to wait longer than others before introducing the euro.

If there are such gains to be made from a common currency in a reunified Europe, would it not be possible that such gains may also be attained on a global level? Should we continue on a path towards more global monetary cooperation? There are many arguments both for and against such an arrangement. In recent years we have seen substantial exchange rate fluctuations between some of the world's large economic blocs. These have largely been related to developments in the US dollar. The dollar's weakening against the euro has recently gained impetus once again; in two years, the euro/dollar exchange rate has gone from a low of 84 cents to 1.18 dollars in recent weeks - a rise of just over 40 per cent. Discussions of the implications of an overvalued dollar for the US current account deficit have quickly turned into concern over the effects of the rapid fall in the dollar on euro area growth. Should there be a quicker correction in the US current account deficit due to diminishing interest among international investors in US assets, the dollar could weaken further. A fast and dramatic depreciation of the dollar could derail Europe's fragile recovery.

But in addition to this concern over excessively sharp movements in exchange rates, an equally heated discussion has flared up in recent months, both in the US and Europe, as to whether the perhaps most important fixed peg that exists today between two major international currencies, that between the US dollar and the Chinese renminbi, should be abandoned. For the past decade, the Chinese currency has been pegged by the People's Bank of China at a rate of around 8.28 renminbi per dollar. Critics of this policy, mainly leading US politicians and some industrialists, believe that Chinese exports have been given an unfair advantage when the renminbi has tracked the dollar's fall against the euro.

The most drastic answer to these exchange rate issues would be to propose a new global monetary system of the kind that existed after the Second World War and up to the early 1970s in the shape of the Bretton Woods Agreement and the link via the dollar to gold. This kind of solution has actually been recommended by Robert Mundell, a currency area theorist and winner of the 1999 Nobel Prize in Economic Sciences. Even Keynes considered the establishment of a global currency, the bancor. Mundell points to transaction gains for trade and the financial markets, but also other arguments. One of these is that the signalling of international relative prices is distorted by exchange rate fluctuations caused by capital flows. Another is that the global economy has led to increasingly weak money illusion, the illusion that prevents wage-earners from immediately perceiving a deterioration in their purchasing power following a depreciation, and from demanding compensation that would render the depreciation ineffectual. Despite the intellectual appeal of such arguments, it is not difficult to see that during the past decade, the US, Europe and Japan have had very different growth rates and their business cycles have been highly unsynchronised. Given that monetary policy would be dictated by the monetary system, a tremendous burden would be placed on fiscal policy to stabilise the economy when the differences across the common monetary area are too great. The large real adjustments that would be required in wages and relative prices in the US and Europe - instead of an adjustment in the exchange rate - would probably cost more than the gains derived from having fixed global exchange rates.

Therefore, the requirements necessary to make such a system work, which in reality are the factors that determine what constitutes an optimal currency area, indicate that such a solution is a distant prospect, if it should become reality at all. In addition, there are the practical and administrative problems of organising such a global monetary system, indeed even a global central bank with representation from all countries.

A middle ground between a single currency or single monetary standard such as Bretton Woods, and fully floating exchange rates, would be intervention bands and controlled exchange rates between, for instance, the euro and the dollar. However, this would partly suffer from the same problems as a fully fixed regime. Furthermore, we would encounter the same dilemma that characterised all semi-fixed, or fixed but adjustable exchange rate arrangements, which failed so miserably over the past ten years. The list is long, from Sweden's and the ERM countries' crisis at the beginning of the 1990s, to the crises in Mexico, Asia, Russia and Brazil during the subsequent decade. All displayed some similar characteristics, which a controlled exchange rate between the dollar and euro would also be unable to escape. At some point in time, the market becomes aware that the political gains of avoiding painful real adjustments are probably less than the costs and loss of prestige associated with an exchange rate adjustment. Once the market realises this, speculation follows and the costs of defending the exchange rate mount, at the same as the potential loss of prestige from adjustment diminishes. In the end, an exchange rate adjustment becomes economically unavoidable and politically acceptable - regardless of whether politicians wanted it. Of course, such a spiral is not possible with a single currency where adjustments must occur without devaluation and where speculation of this kind is impossible.

Do not these arguments lead us to conclude that China too should let its currency float? After all, China is one of the world's largest economies that in spite of its increasing openness follows a course of its own. Critics of the dollar peg believe that if the renminbi were allowed to float, it would appreciate, thus reducing China's current account surplus and shrinking the US deficit. In the long term, I believe that it is right to allow the renminbi to float. In the short term, however, it is difficult to see this as the appropriate solution. The main reason for not floating the renminbi yet is the Chinese financial system. The Chinese banking system is still a long way from being adapted to market conditions, and a large proportion of its lending is still made to state-owned companies that are often unable to honour their payment obligations. If we take into account all the hidden and disclosed non-performing loans in the banking system, these are estimated to be equal to as much as half of China's GDP, and they are continuing to grow. Were the currency allowed to float before addressing these problems, it is just as likely to depreciate as appreciate since the Chinese public could take advantage of the opportunity to transfer its assets abroad instead of saving at low interest rates in the weak domestic banking system, a system that would then be rocked to its foundations. The experiences of many countries, including Sweden at the beginning of the 1990s, show that the foreign exchange market should not be deregulated until the banking system has been reformed.

Could China not revalue then and adapt the exchange rate to its trade surplus without floating its currency? In my opinion, this would not be such a wise decision either. It is wrong to attribute China's trade surplus with the US to the currency issue. The surplus is probably best explained by the cost advantages enjoyed by Chinese producers in labour-intensive goods compared with the US. China's trade surplus can be seen as a natural consequence of the division of labour within the Pacific region where China's position as supplier and sub-supplier of low value-added goods is highly favourable for US productivity. This is a segment in which the Chinese compete with very few US producers, which is why an exchange rate adjustment would have only a marginal impact. In actual fact, an excessively large one-off adjustment would be required to have any effect at all on the US-Chinese trade balance. Such a large correction would in turn give rise to problems for Chinese trade elsewhere. It is with the US that China enjoys a large surplus, while the trade balance is close to zero or is negative with many other areas, including the euro area. This picture is confirmed by many fundamental analyses of an equilibrium exchange rate for China, which come relatively close to China's fixed exchange rate today. Furthermore, China currently has either very low inflation or deflation, which normally points to devaluation pressure rather than revaluation pressure (a need for real depreciation). Finally, China and other the Asian economies that are trying to prop up the value of their currencies are the main purchasers of US Treasury bonds. So, in a situation where the US government finances are deteriorating, the Chinese exchange rate regime is actually helping to depress US long yields and indirectly bolstering the US recovery.

My conclusion is that China in the short term should retain its fixed exchange rate until such time as its financial system has undergone more substantial reform, which is something that nevertheless must be done in the coming years. In the long term, however, a floating exchange rate appears unavoidable for a country that is on the way to becoming one of the world's leading economies. It is only in the much longer term, when China is highly integrated with the world economy, that fixed exchange-rate cooperation can become a possibility once again.

This conclusion brings me back to the main line of my argument: Europe can gradually be enlarged to become a relatively big currency area that includes all the countries, from Ireland in the west to Estonia in the east, where the long-term microeconomic gains outweigh the recurring but temporary macroeconomic costs. As the representative of a central bank, I must add that it is interesting to at least toy with the idea of how a global currency and global monetary policy would look. But for the time being this will probably remain no more than an intellectually stimulating vision. At global level, integration needs to go much further, and the economies become more synchronised, if the long-term gains of fixed exchange-rate cooperation are to outweigh the risks.

In the long term, it is not inconceivable that a trend will arise towards large regional currency blocs with single currencies, but with flexibility between them. Within these blocs, it will be possible to reap the advantages of integration fully, while the risks will be limited by increasingly similar conditions in the countries taking part in the common currency. Competition between these areas regarding which has the dominant reserve currency may increase gradually. The dollar's unique position will weaken, just as we are seeing today with a number of Asian central banks planning to increase their assets in euro and reduce those in dollars. Let us hope that there will also be cooperation between the regions, so as to give the world greater stability, development and continued integration.