Lars Heikensten: Euro entry before reforms or reforms before euro entry?

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at the Frankfurt European Banking Congress, Frankfurt, 21 November 2003.

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The outcome of Sweden's referendum was an unambiguous "no" to euro adoption. This means business as usual for Swedish monetary policy. Since 1993 we have had an inflation target of 2 per cent, which has gained credibility with the public and the markets. Since the introduction of the inflation target, inflation has averaged 1.7 per cent while average growth has been 3 per cent. This compares well with the Swedish experiences of previous decades. It also compares favourably with the recent performance of the euro area. This relative strength of the Swedish economy was in my opinion an important factor behind the result in the referendum.

However, the outcome of the referendum does not mean business as usual in our relations vis-à-vis the rest of Europe. We will not have a seat at some of the negotiating tables in Frankfurt and Brussels that we could have had. Of course, we will try to compensate for this. To some extent, this can be done by keeping our own house in order - by conducting sound economic policies. Also, we will do our utmost to contribute to European policy discussions. Being outside the euro certainly doesn't mean that we want to be on the margins of the debate on monetary integration in Europe.

Sweden remains a 'pre-in'; we will have to consider euro adoption again at some point in the future. Therefore the evolution and enlargement of the euro area concerns us. Secondly, Sweden is probably one of the EU nations that will benefit most from the enlargement of the European Union. Our economy is one of the EU's most integrated with acceding countries, with surging East-West trade and FDI. Also, should Estonia, Latvia and Lithuania adopt the euro, we would be directly affected because Swedish banks own most of the Baltic banking system.

I would therefore like to share some reflections with you on two subjects of relevance to euro area enlargement: the risks associated with ERM II membership and long-term frameworks for fiscal policy.

However, before doing this let me stress two things:

First, the long-term advantages of euro area enlargement are evident. I believe the advantages would be roughly the same for acceding countries as they would be for Sweden: integration of trade and capital markets stimulates growth for both the euro adopter and the euro area. In the case of acceding countries, there are probably additional advantages of monetary integration; it gives added stability after the difficult years of transition and is important for their underdeveloped financial sectors. So the issue is not really euro area enlargement as such, but rather its timing and preconditions.

Second, from the perspective of the euro area itself it is hard to see how acceding countries could pose any major risks to price stability. The sum of the economies of all the new member states does not presently amount to more than the GDP of the Netherlands. Furthermore, historically high inflation rates in the acceding countries have been reduced through reinforced macroeconomic discipline (which in turn owes much to the enlargement process). A simple calculation shows that even if growth in the acceding countries averages some 4 per cent more than the euro area, and this catch-up, according to most estimates, generates Balassa-Samuelson price convergence with 2-3 percentage points higher inflation than euro economies, their inclusion in the euro area would still only add some 0.2 percentage points to area-wide inflation. Instead, it is the perspective of the acceding countries themselves that is crucial.

Risks with ERM II

The one risk with ERM II that has been discussed at length in recent years is the potential conflict between a pegged exchange rate and an inflation target. Both exchange rate stability and low inflation are necessary to fulfil the conversion criteria, but in some cases it may be difficult for monetary policy alone to meet two targets at the same time.

One possible situation is that the central parity has been set too low and that real appreciation pressures, due to catching up, are so strong that the upper band comes into question. This can result in large-scale speculative currency flows and unnecessary turbulence, as demonstrated by the attack on the forint at the beginning of this year.

The obvious solution to speculation against the upper band is to reach an agreement in ERM II to revalue. But this is often difficult in practice. When political decision-makers are forced to choose between the inflation and exchange rate targets, it takes courage - and good analyses - to give priority to low inflation and opt for revaluation. As the case of Ireland has demonstrated, this does not exclusively apply to acceding countries. In the end, the result can be inflationary pressures once inside the euro area.

However, the most acute risk with ERM II is probably when the exchange rate is in the lower part of the band. Virtually all the currency crises that we have experienced in recent decades have been due to speculation against weak currencies. ERM II, of course, is different from these previous failed regimes of pegged exchange rates in the sense that it has a clear exit strategy with regard to euro adoption. But this does not mean that ERM II is immune to large fluctuations in short-term financial flows.

I do not think this should be a big problem for the currency board regimes or the so-called hard pegs in the new Baltic member states. In their case, ERM II membership would merely be confirmation of a credible regime that has been successfully maintained for nearly a decade, even when confronted with severe shocks such as the Russian crisis. This has been possible thanks to a high degree of wage flexibility as well as serious efforts to achieve fiscal consolidation.

There is more reason for concern over some of the presently floating regimes as they move towards ERM II. Substantial fiscal slippages have occurred in some of these countries, bringing them far from the 3 per cent deficit requirement. In most cases the deterioration has not been a consequence of additional costs related to accession; neither has it mainly been the result of automatic stabilisers - these are considerably smaller in acceding countries than in present EU members. Instead, the large - cyclically adjusted - deficits reflect increases in public wages and so-called mandatory social spending, combined with a lack of expenditure cuts in other fields. Consolidation is planned to take place mainly in the medium to long term, and deficits are only set to be reduced to levels compatible with the convergence criteria towards the end of the decade (Fig. 1).

Some of my central bank colleagues from the new member states argue that rapid entry into ERM II and the target of an early euro adoption is precisely what will force politicians in their respective countries to improve fiscal policy. In the words of one of my most eminent colleagues: “delay in entry equals delay in reforms”. Of course, I can understand this argument, and in the end it hinges on the political economy of each country. But using ERM II as a straightjacket is a risky strategy. It is all too reminiscent of the period 1990-92 in Sweden when the “nominal anchor” of the ECU peg was supposed to “bind us to the mast” but ended in a macroeconomic shipwreck. A botched entry into ERM II, with increasing public deficits, will be prone to economic and political instability. Furthermore, if meeting the convergence criteria is viewed as the main leverage for fiscal reform, it is worth remembering that this particular leverage disappears on EMU entry.

A framework for fiscal policy

This brings me to my next topic: fiscal policy frameworks for countries in the currency union. This is an important issue, partly for the stability of the union as a whole. It was also the perspective behind the Stability and Growth Pact. But strong frameworks for public finances are also important for each individual country when they no longer have an independent monetary policy. Only if fiscal policy is in order can asymmetric shocks be dealt with in a reasonable way.

The risk of asymmetric chocks is not necessarily higher in the acceding countries than in many of the present member states; in some cases it might even be smaller. A number of studies point to a relatively strong correlation in acceding countries with the business cycle of the euro area. However, it would be unwise to assume that no important asymmetric shocks relative to the rest of the euro area cycle will ever occur. Also, there are risks of domestically generated “political” shocks due to policy mistakes. We have had examples of this in Sweden and it could also happen in some other countries.

How can euro adopters prepare public finances for asymmetric shocks? This was a major issue in the Swedish debate ahead of the euro referendum. Despite the fact that there had been reforms in the public-finance framework in Sweden in the 1990s, the Riksbank and others argued that more should be done before joining the euro area.

Essentially two things are required:

First, there is a need for sufficient margins in the public finances. In practice, this means that debt levels should not be too high. If the economy enters a downturn that does not affect the rest of the euro area to the same extent, it is important that there is scope to conduct more expansionary policy. If the scope is there, one can be reasonably sure that it will be used.

It is more difficult to handle the second, opposite situation - upturns and over-heating tendencies. What is then required is a framework that stimulates or even forces political decision-makers to act in time and to take decisions that might be difficult in the short run but that are correct in a longer perspective. Here we drew some inspiration from our monetary policy set-up. Fiscal policy could be guided by clear targets that are defined in terms of countries' output gaps. Alternatively, national inflation targets could be introduced. In combination with transparent processes, including recurrent evaluations by national parliaments or in other arenas, this could put pressure on politicians to act.

Is the Stability and Growth Pact not sufficient in itself? After all, it is designed to ensure fiscal discipline in the member countries. The answer here is clear; it could have been had the Pact only been followed. But now the situation is different. As the Pact has not been followed by the larger euro countries, there is a risk that the newcomers will take the same attitude. However, this could be a dangerous conclusion. It would be wiser to look at the issue the other way round. Both Germany and France attained the 3 per cent mark for the public deficit criterion by the narrowest of margins despite what was a global upturn. But they clearly did not do enough afterwards in terms of consolidation, despite intense pressure from many of the smaller countries. Today, this is a significant problem not only for the euro area as a whole; the countries themselves are also paying the price in terms of a deeper and longer downturn. This, if anything, is a warning to new euro adopters.

Conclusions

Having raised these complex issues, let me be very clear about my sentiments. I do not wish to see any new obstacles or separate rules for the new member states; equal treatment is essential. No other rules for convergence should apply to the new euro adopters than those that have applied to present euro area participants or that would have applied to Sweden if we had voted "yes" to adopting the euro. Indeed, early euro adoption may be entirely beneficial for those new member states that have sufficiently stable and flexible economies and that have followed a course of fiscal prudence for a long time, just as I personally would have considered it beneficial for Sweden had we joined in 2006.

Rather, it is in the euro adopters' own interests to independently consider the risks. Countries that have used exchange rate flexibility should not rush into a system of fixed exchange rates before the conditions are right. If you have not already achieved fiscal discipline, do not enter ERM II nor opt for early euro adoption as leverage on the politicians to bring about such discipline. It is not only a matter of meeting the 3 per cent convergence criterion but also of reaching a maturity in fiscal policy that includes a transparent and predictable fiscal framework with sufficient room for manoeuvre for stabilisation policy. The road to the euro may otherwise become very rocky, and if the euro is eventually adopted, the trade-off between fiscal rectitude and stabilisation needs may become a recurring problem.

My advice would be to put your house in order first, and only after that enter ERM II and begin a quick process of euro adoption. Then you will have the best possible guarantee to reap the full benefits of monetary union.

Thank you.

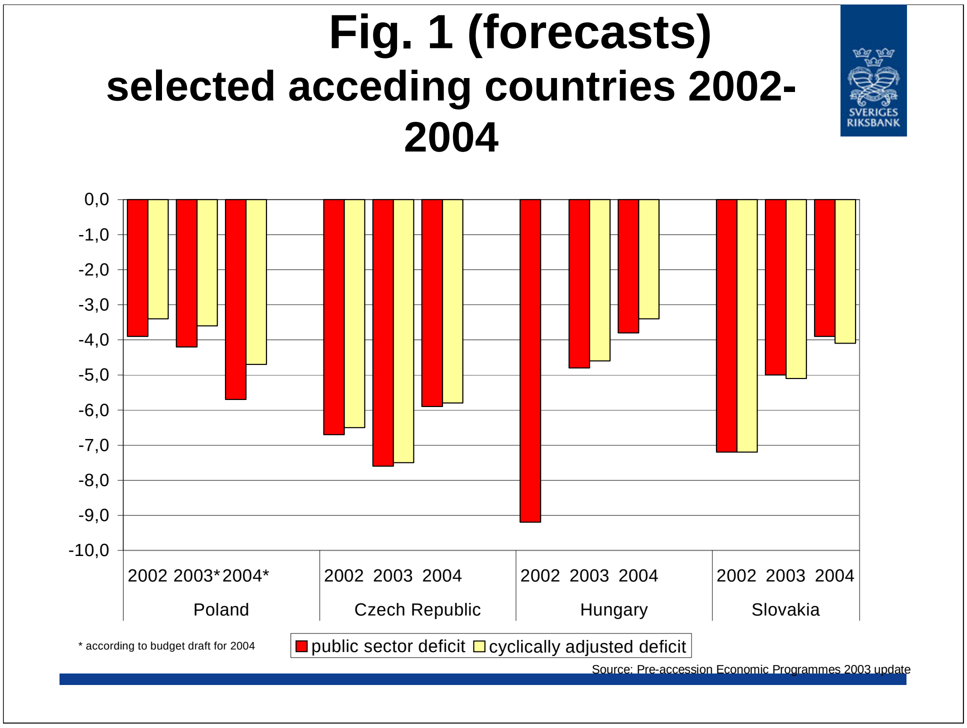
Fig. 1 (forecasts)
selected acceding countries 2002-2004
SVERIGES RIKSBANK
0,0
-1,0
-2,0
-3,0
-4,0
-5,0
-6,0
-7,0
-8,0
-9,0
-10,0
2002 2003* 2004*
Poland
2002 2003 2004
Czech Republic
2002 2003 2004
Hungary
2002 2003 2004
Slovakia
* according to budget draft for 2004
public sector deficit
cyclically adjusted deficit
Source: Pre-accession Economic Programmes 2003 update