Mr. Heikensten looks at the consequences for Sweden of joining EMU

Speech by the Deputy Governor of the Bank of Sweden, Mr. Lars Heikensten, at the Baker & McKenzie's EMU seminar held in Stockholm on 5/2/97.

First a word of thanks for the invitation to talk with you about Sweden and the European Economic and Monetary Union. Today I have chosen to consider this matter from three angles: general aspects of the issue of Sweden and EMU; the work we did last year in the Union to prepare for EMU; and some consequences of EMU for Sweden's financial sector.

The EU's preparations for the economic and monetary union are continuing. The member states are doing all they can to fulfil the economic criteria for participation in the euro area. Along with this, intensive political work is being done to remove any remaining obstacles. After the latest meeting of Heads of State or of Government, in Dublin last December, political agreements are in place on, for example, the stability and growth pact and the relationship between the euro and outside currencies.

Solutions are still required on a number of important issues. One is how the path into EMU is to be arranged for countries that do not belong to the first group. Then there are many technical details to adjust in the course of the year. But the puzzle's main pieces are now in place.

EMU - an important part in EU cooperation

When asked about the likelihood of EMU being actually established on time, some observers declare that "the EMU process has reached a point of no return". I neither can nor want to be so categorical. But that EMU will be realised on time in accordance with the Treaty does seem highly probable. The political determination is strong, as has been demonstrated time and again when conflicting views threaten the process.

I am glad the debate has now started in Sweden and that it is concentrating to a greater extent on the consequences *for Sweden* of joining the monetary union or remaining outside, rather than on whether the EMU project as such is good or bad. What I still lack in the debate is an appraisal of EMU in a broader policy perspective. The purpose of the economic and monetary union is the same as for the European Union: closer European cooperation on such areas as integration, growth, employment and prosperity.

The European Union is often discussed in Sweden in terms of a Brussels bureaucracy that deals with the length of cucumbers or the curve of bananas. That is of course both incorrect and unfortunate. The Union should be seen as an arena or, if you like, a playing field. For some years now Sweden has been a player, which involves learning the rules and taking initiatives for the development of Europe in concert with other countries. But this presupposes that, instead of again remaining outside, we participate in the contexts where developments are constructed.

Opportunities and risks

The idea behind a single currency in Europe is simple. One currency is better than many - it makes things work more efficiently. Eliminating the need to exchange currencies reduces transaction costs. The exchange rate stability facilitates trade and investment. A single currency makes price comparisons and economic estimates easier, not least for small and medium-sized companies. More direct price comparisons should lead in turn to stronger competition and downward pressure on prices, to the benefit of consumers.

But risks are also involved when a single currency is introduced in so many countries with geographical, cultural and institutional differences. The Calmfors report has highlighted the insurance argument. I agree that this is an important point against EMU and therefore warrants particular attention. Monetary and exchange rate policy can be used as a kind of insurance against major, unforeseeable shocks in a single country. Without it, large adjustments may be required in other parts of the economy.

However, when Calmfors and others claim that country-specific shocks have been more frequent in the Swedish economy than in the EU's core countries, they are on uncertain ground. There are many indications that the shocks in Sweden have been occasioned above all by domestic economic policy and other institutional conditions, in the labour market and in wage formation. Wage costs in Sweden rose considerably faster than in other countries in the 1970s and 1980s; competitiveness was restored by resorting to devaluations.

It is not self-evident that shocks generated externally would hit Sweden more seriously than countries which are currently taken as given for EMU. So the risk of what economists call asymmetric shocks in Sweden should not be exaggerated.

Moreover, when it comes to influencing production and employment in the event of major shocks, monetary policy has a limited capability. It may even be the case that independence in monetary policy increases the risk of self-inflicted shocks. In the longer run, monetary policy is not a substitute for the changes that need to be made, for instance to improve wage formation and the workings of the labour market.

The Governing Board of the Riksbank will shortly be submitting an opinion on the Calmfors report. The arguments for and against EMU participation will be considered there at greater length. A general theme in the report is that every kind of decision - to joint now, to join later or to stay outside - entails risks and has a price. Although the report conclude that Sweden should wait joining EMU for the time being, not much is needed to tip the scales the other way, for example if EMU begins with more participants than the core countries or if the alternative of remaining outside does not confer any substantial freedom in monetary policy. But as I said, there will be occasion to return to this.

Preparatory work in the EU

The preparatory work is in full swing in all the EU institutions as well as in the member states. The EMU project will not founder on technical aspects.

In May 1995 the Commission presented a green paper on the practical arrangements for a changeover to the single currency. At the Madrid meeting that year the European Council adopted the scenario for the changeover, specifying dates for the central decisions. The Council confirmed that Stage Three of EMU is to start on 1st January 1999. The decision on which countries will participate in the euro area is to be made as early as possible in 1998 (probably February--April) on the basis of which countries fulfil the convergence criteria in respect of statistics for 1997. Euro banknotes and coins are to be in circulation by January 2002 at the latest.

The preparatory work last year was dominated by two issues: one was what is now called the growth and stability pact and the other was the nature of the relationship between the euro and the currencies outside the euro area. A common factor in these matters is the question of maintaining stability once EMU has been established.

1. Growth and stability pact

Without specific restrictions, participation in the euro area would make it easier for a country to implement an expansionary budget policy. When national currencies disappear and the interest rate largely reflects the single monetary policy, some of the immediate signals to politicians and other decision-makers will disappear. Access to the large, uniform capital market that will result from EMU will also make it easier to borrow. Up to a point, of course, this is good; it eases the tax burden in countries with a large government debt, for example. But it also involves risks, above all that a country abuses the situation so that ultimately it is other countries which may have to pay when failure threatens.

The Maastricht Treaty, as most people probably know by now, contains a number of conditions that member states have to fulfil in order to participate in the euro area. Once countries have joined the euro area, however, there are no correspondingly strict rules. This is where the growth and stability pact comes in.

The purpose of the pact is to get participating countries to strive for a cyclically balanced budget or a surplus position. Deviations from this target are to trigger alarm signals whereby the Council starts to take action in the form of examinations, advice, recommendations, publication and, ultimately, sanctions. The monitoring of economic development in member states is to be reinforced with a mandatory stability programme, similar to the present convergence programme. In the event of a country having an excessively large budget deficit, its government must act. If adequate measures have not been taken within ten months, the country will be required to deposit a no-interest fee with the EU Commission. If the deficit is still excessive after two years, the fee is transformed into a fine. At most the fine can amount to the equivalent of 0.5 per cent of GDP.

If the deficit is due to exceptional circumstances, sanctions are not to be imposed. If GDP falls by 2 per cent, no sanctions are to be levied for an excessively large budget deficit. The Council can also decide not to impose sanctions if GDP falls by between 0.75 and 2 per cent and other “special circumstances” apply.

While the point of a system for preventing the abuse of fiscal policy in EMU has always been clear, one cannot turn a blind eye to the risks inherent in rules such as those in the stability pact. It is thus a matter of striking a reasonable balance between different interests, which is why the discussion has been so protracted. The risks are mainly of two kinds:

- One has to do with the need of *adjustment mechanisms*. With no possibility of using monetary and exchange rate policy at the national level, it may be important for the system to provide other “buffers”. Therefore the pact ought not to be so strict that it might in practice have a destabilising effect in a particular country with problems.

- The other concerns *credibility*. What would happen if the threat of sanctions fails to act as a deterrent? Will the European political system be capable of punishing a member state?

The main features of the growth and stability pact have been established. It remains to draw up specific rules about, for example, the monitoring of exchange rate stability, the construction of the stability programme and the legal framework. Finally it may be worth mentioning that the monitoring routine and the excessive deficit procedure will be essentially the same for countries outside the euro area, except in one respect - the sanctions.

2. ERM 2

The Dublin meeting also decided that a new exchange rate arrangement, ERM 2, is to be set up as the dominant mechanism for the coordination of monetary policy and other economic policies between the member states in the euro area and those that remain outside. The system will resemble the existing ERM except that this is a multilateral system of rates for conversion between all the member currencies, while in ERM 2 the currencies of non-participating countries will be linked directly to the euro.

The risk of systemic tensions with ERM 2 will probably be smaller than it has been earlier with ERM because the degree of convergence in the EU area is now greater. Moreover, the band on either side of the central rates will probably be relatively broad. The experience gained in 1992-93 has also resulted in a greater readiness to adjust rates when this is considered necessary. But of course speculative situations cannot be ruled out either in the present ERM or in ERM 2, as is clear from developments in Finland in recent months.

The Swedish position has been to avoid making the new exchange rate arrangement mandatory. Basically, we consider it would be better to achieve coordination in Europe with a single inflation target. We find the present construction of Swedish monetary policy satisfactory. But we can get along with the system that has been chosen. Cooperation will not be mandatory, which means that monetary policy can be conducted with an inflation target as well as with a fixed exchange rate with the euro. Still it is clear that there will be strong pressure on us to participate in ERM 2. It is also conceivable that a period of participation in the exchange rate mechanism will prove to be a condition for EMU membership. In any event, as a EU member state we have undertaken to conduct exchange rate policy as “a matter of common interest”.

Changeover plan for the financial sector

It is the Riksdag (Sweden’s parliament) that decides if Sweden should join EMU. The Riksbank has the task of helping to ensure that Sweden does in fact have a choice when the time comes to decide, so that Sweden is ready to join if a Riksdag majority so requires.

The Ministry of Finance and the Riksbank each have an organisation for the euro’s practical introduction. The scale of the systemic changeover is tremendous, roughly on a par with our earlier change to driving on the right-hand side of the road. A fundamental principle for the work is that, as far as possible, all those concerned are to find their own solutions to the problems posed by EMU.

The Riksbank is responsible for the changeover in the financial sector. To this end we have set up a body called SIFS (the Swedish acronym for Consultation and Information to the Financial Sector). One result to date is a report, published a few days ago, on the situation as regards the euro in Sweden’s financial sector.

Good progress has been made in the preparatory work. Timetables and suitable solutions have been established in a number of fields. The Riksbank considers that the financial sector can manage a changeover to the euro on 1st January 1999. Participation from a later date can facilitate the preparatory work in certain respects and complicate it in others. The worst alternative is a long period of uncertainty; that would entail a costly duplication of systems in many fields.

I should like to end with some examples of changes that will occur and be of importance for the financial markets.

1. Monetary policy

A single currency presupposes a single monetary policy. In EMU this will be implemented by the ECB. In this context the national central banks will function as “operative arms”, acting on instructions from the ECB.

For Swedish banks and financial institutions, the difference as regards participation in central bank monetary policy operations will probably not be all that great. The Riksbank will no doubt continue to be the financial sector’s counterparty. The main differences from today for Swedish banks are that the overnight market will be considerably larger and that minimum reserves are likely to be required.

How monetary policy is to be constructed and implemented in detail has still to be decided. These matters will not be finalised until the ECB has been established next year. Thus it is the countries which participate from the start that will be in a position to influence the conduct of policy as well as the organisation of the work in the new European bank. There are already tendencies for countries belonging to the “presumed” core to exercise a greater influence over the process.

2. Payment system

A single monetary policy calls in turn for a common payment system in order to handle the payments connected with the policy’s implementation. The arrangements whereby all the national systems are interlinked is called the Target system.

In the new system, a cross-border payment will normally be made in a matter of seconds, whereas at present in the best case it takes a whole day. The main objective of Target is to enable the ECB to implement monetary policy but the new system will also provide a new “highway” for commercial transactions. The extent to which banks and other enterprises use the system will probably depend on the price.

All the national central banks in the EU area can join Target, whether or not their country is in the euro area. But there is a considerable risk of countries outside the euro area being in a worse position, for instance due to restrictions on intra-day borrowing in euro to counter fluctuations in the payment flows. We have vigorously opposed this threat of discrimination but the issue, along with others, has been deferred and will now be decided by the countries that join the euro area from the start.

3. Legal framework

A clear legal framework for the euro is essential. Economic values, for instance in contracts, bank accounts and pension agreements, must be guaranteed during the changeover period from 1999 to 2002, when the euro and national currencies will exist side by side. The so-called continuity of contracts is regulated in one of the euro statutes but amendments to national laws will also be needed.

Another legal issue concerns the national central banks. As regards the Riksbank, the Maastricht Treaty calls for a more independent statutory status. This means, for instance, that the status of the Governor must be clarified; grounds for his or her dismissal will have to be explicit, e.g. serious misconduct, etc. Neither will the Riksbank be able to accept directives, except of a statutory nature, from others, e.g. the Government. The composition of the Governing Board may be a problem; the appointment of members of Parliament to the Governing Board runs counter to traditions in Central Europe.

4. Debt conversion and issues

The countries that join the euro area may - and it is also envisaged that they will - issue treasury paper denominated in euro. A member state wishing to convert its stock of debt into euro will be allowed to initiate the appropriate measures. A member state may also take steps whereby private issuers and marketplaces (e.g. the Stockholm Stock Exchange, OM and the Securities Register Centre) can switch to euro in the changeover period. Many institutions and agents are in fact planning to do this.

All private economic agents are to be free to choose between using euro from the start of Stage Three and waiting until the changeover has been completed. However, the agents in the Swedish securities market, banks, financial institutions, the Securities Register Centre, the Stockholm Stock Exchange, OM and others are unanimously in favour of a “big-bang” solution, that is, a quick, concerted changeover from kronor to euro right from the turn of 1998.

5. Banknotes and coins

Euro banknotes and coins will not be introduced until the beginning of 2002. For a time, commerce will have to cope with two sets of prices, one in krona and the other in euro. A timetable for the substitution of banknotes and coins is to be fixed by each country. For Sweden the Riksbank hopes that the changeover can be arranged in an appreciably shorter time than the allotted six months.

It should be underscored, finally, that EMU is likely to bring about notable changes in the financial landscape. Some products will simply disappear: currencies, as well as forward and option instruments derived from them. With a single monetary policy and no exchange risk, interest rate differentials between national treasury papers will arise only from credit risk. The market for Swedish treasury paper will be more or less integrated in a market for treasury paper in euro. Provided the debt situation in the countries concerned is under control and reasonably similar, national T-bonds will become close substitutes. That will also do away with a number of national forward and option products.

Certainly there will be new financial products; there has been no lack of creativity in this field in the past decade. There will clearly be increased competition between financial institutions as well as between financial markets in different locations.

There is nothing new about the globalisation and integration of the world’s financial markets but it is reasonable to suppose that EMU will accelerate the process.

Summary and conclusions

Today it looks for the most part as though economic and monetary union will start as planned on 1st January 1999. For Sweden the question is whether we are to participate from the start, wait a while or try to remain outside for ever. Recently the discussion of this issue has finally got going. My view has been that it is not just a question of economics, though the economic arguments do point to participation. EMU is one important component of the EU cooperation in which Sweden is now taking part.

From the debate about economic aspects of EMU one sometimes gets the impression that an alternative exists which is much simpler, enabling us to avoid all the adjustments which Brussels imposes. That is not the case. Sweden has experienced a profound economic crisis in the 1990s that was essentially self-inflicted. Development in the rest of Europe has on the whole been better. We must now in any event continue to consolidate government finance and establish long-term confidence in the stability of Swedish economy. This will scarcely be easier outside EMU.

I find it hard to envisage that Sweden would ultimately want to remain outside a functional EMU. Bit by bit the countries of Europe will grow together. This makes the question not whether but when Sweden ought to join. Perhaps this perspective can help to make the question less dramatic.

In our efforts to prepare the financial sector for EMU we can see that the work has come a long way. We also meet a strong desire from the parties concerned to get going as quickly as possible so as not to fall behind; so as to compete on the same terms as other European enterprises and not lose business opportunities.

My own experience of EU cooperation prompts the same conclusion. As a “free rider” alongside EMU it is not just business opportunities that we lose but also influence on European cooperation.