

## **Lars Heikensten: EMU - cohesion or diversity?**

Speech by Mr Lars Heikensten, First Deputy Governor of the Sveriges Riskbank, to The Swedish Institute of International Affairs, Stockholm, on 10 November 2000.

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First a word of thanks for inviting me to speak. I greatly appreciate the opportunity of talking about matters to do with European integration to an audience outside the circles in which I normally move. This is all the more stimulating given that there is little more than a month to go before Sweden takes over the presidency of the EU Council of Ministers.

I intend to begin by saying something about the history and principles behind the European Monetary Union and how they can be related to our theme today: cohesion or diversity. Although EMU was fully launched so recently, I must then comment on what has happened to date, as regards economic developments as well as the economic policy cooperation. I shall then briefly conclude with my view of the future for EU's economic policy cooperation.

### **Political as well as economic grounds for a monetary union**

Let us bear in mind that none of the things we are discussing today are entirely new. Common currencies were in use more than a century ago and some of them were valid throughout the continent of Europe. A joint standard and a rapidly growing economic exchange were already seen as natural goals around the turn of the 19th century. The Great War broke that trend, however, and both the Scandinavian and the Latin monetary union were dissolved.

The EEC, predecessor of the European Union, was established after World War Two primarily as a project for peace. Political integration was the objective, to be achieved in large measure with economic means. When the Treaty of Rome, which established the EEC, was signed in 1957, there was already talk of a need to supplement the economic integration with a monetary union. When these ideas found expression in the 1970 Werner Plan for economic and monetary union, monetary and fiscal policy cooperation were equally prominent. According to the Plan; EMU would become a catalyst for the development of a political union without which it cannot ultimately survive.

The currencies of Europe had already been linked up by the Bretton Woods agreement on international monetary cooperation. The Werner Plan extended this with the prospect of a single monetary policy and, in time, a single currency. In the present context it is worth noting that the Plan's primary thrust was for increased economic coordination, above all the notion of harmonising the member countries' stabilisation policies in order to avoid tensions. Pierre Werner, prime minister of Luxembourg, and the central bank governors on his committee proposed an economic policy centre that would control national budgets, regional, structural and social policies. The whole process would be crowned by the single currency.

When the Bretton Woods system collapsed and the oil crises erupted, national considerations put a stop to the Werner Plan. With the advent of the EU's internal market in the 1990s, however, the issue of a common currency was revived. National currencies came to be seen as the last major barrier to the internal market's full impact, which would pave the way to even greater European integration.

To a large extent, the driving force behind the Werner Plan and the Maastricht Treaty was political. Experience has taught us that institutionalised economic cooperation can be an antidote not just to trade conflicts but even to war. A common currency is a strong political symbol that can render cooperation durable in the daily economic round. Instead of being just a topic for solemn speeches on television, European cooperation with a single currency could be something real that people carry around in their purses and pockets.

But the Maastricht Treaty was, of course, also backed up by the strong economic forces that lay behind previous attempts at monetary union. By reducing exchange risks for firms, a single currency facilitates cross-border trade and investment. It also helps to integrate capital markets, rendering them larger and deeper, which aids the supply of corporate capital in Europe.

These considerable effects are accompanied by others that we ought not to underrate. In the present situation, moreover, they are likely to be enhanced by the internet and other new information technology. Not the least of these is that the monetary union eliminates the psychological barrier that different currencies raise when we try to compare prices in different countries. The result is greater transparency and stronger price competition. Price differences in Europe today are twice as large as in the United States. The price of a small car, for example, can vary more than 50% between EU member states.

### **Risk of countries getting out of step**

However, the road to greater cohesion is not necessarily smooth. In a monetary union, forces are at work that may cause member states to develop in different directions instead of converging. Discussions about EMU often raise the topic of asymmetric shocks, a technical term that stands for something quite simple. The conditions for the countries involved differ initially as regards their economic structures, for example the corporate sector, the level of technical development, wage bargaining systems and competitive pressure. Economic shocks will therefore affect them differently. Problems may also arise if economic policy in one country is markedly different from the general direction. In Sweden, for example, the economic differences from the EU countries in the 1970s and 1980s were in large measure a consequence of self-imposed stabilisation problems.

If a shock does hit a single country, a monetary union eliminates the possibility of mitigating its effects by adjusting the exchange rate. Neither can this be done by implementing a national interest rate policy. Instead, wages and prices need to be as flexible as possible so they adjust and counter the impact of the shock. Wage formation is accordingly of major importance for enabling the countries in a monetary union to harmonise their business cycles without being hit by unemployment.

Another type of problem in a monetary union can come from differences in the construction of fiscal policy. A national currency and interest rate are no longer available as clear indicators of market confidence in a country's economic policy. This means that a part of the forces which previously tended to discipline pressure for fiscal expansion and counter unduly large budget deficits no longer acts. That applies in particular to small countries, in that their mistakes can be concealed, at least for a time, in the overall development of the monetary union's exchange rate and interest rates. The opposite applies if the large countries commit economic policy mistakes - the consequences are liable to hit the entire union.

In theory, perhaps problems of this kind should not be all that grave. If a euro country's budget is markedly underbalanced and money is distributed to the inhabitants, they ought to be prudent enough to set aside some income to cope with the strains that are bound to come when, sooner or later, the government finances have to be consolidated again. But things don't work like that in practice, at least not sufficiently so. Short-term budgetary expansion therefore normally leads to increased consumption and that in turn is liable to result in higher inflationary pressures throughout the euro area. All else equal, the end result will be that the ECB is forced to tighten its stance a little more. In that way, a less disciplined policy in one or more member states to some extent hits all the countries in the union. In the extreme case, it is conceivable that a country might deliberately refrain from managing a debt problem and, when the crisis becomes acute, try to shift the payments onto the other countries.

Problems of another type have come to the fore with the past year's weakening of the euro. When the mood is negative, every potential problem gets an airing regardless of its weight in practice. Difficulties in small countries, for example in connection with inflation being considerably higher than in the core countries, can then be presented as a threat to the whole, with consequences for the euro's exchange rate.

## **Rules and processes for promoting cohesion**

All the problems and risks I have mentioned were essentially well-recognised and thoroughly discussed before the EMU was formed. Various rules were therefore constructed to prevent what is called destructive diversity.

The Maastricht Treaty, for instance, includes rules to prevent excessive government debt being dumped onto others. This is explicitly prohibited by the ban on government financing in the central bank. The Treaty also rules out privileged access to bank loans as well as bail-outs by other countries or the EU as a whole.

The most important concrete instrument for promoting cohesion is, of course, the EU's convergence criteria for EMU participation: low inflation, low interest rates, a stable exchange rate and balanced government finances. Much has been said and written about these criteria. I have already suggested that perhaps it is not just these criteria as such that are the key to a monetary union that functions properly, although the part they have played in disciplining policy in a number of member states should not be underestimated. But I do believe they have had the important effect of contributing to a greater consensus than before on issues of stabilisation policy. The Maastricht Treaty's institutional requirements concerning formal central bank independence and the legal infrastructure of the financial sector have also contributed to the consensus that has been achieved and which I believe is central for the proper functioning of EMU.

A remarkable degree of economic convergence throughout the EU was achieved in the second half of the 1990s. If one excludes Greece, the gap between the highest and lowest rates of inflation among EU countries narrowed from 10 percentage points in 1990 to 1% point in 1997. In 1995 the gap in the public finances extended from a deficit of almost 8% of GDP in Sweden to a deficit of 2.3% of GDP in Denmark. By 1997 the gap had narrowed to a 0.1% surplus in Denmark and a 3.0% deficit in Spain. The EMU process also led to more similar levels of interest rates. In many countries the instrumental rate moved down from 10% in 1995 to Stage Three's initial rate, which practice was set already on 22 December 1998 when all the future euro countries lowered their instrumental rates to 3%.

To ensure that the fiscal goals enshrined in the convergence criteria would continue to guide policy in the monetary union, in 1997 the EU member states concluded the Stability and Growth Pact. This Pact's best-known requirement is that a general government deficit is not to exceed 3% of GDP and that if it does, sanctions will be applied. I should like to remind you, however, that the Pact is also intended to promote a balanced development of government finances over the business cycle. All EU member states are required to present annual stability programmes (in the case of non-euro countries, convergence programmes) that are first discussed in the Economic and Financial Committee and later in the Ecofin Council.

In addition to these processes for testing that every country adheres to the rules, Broad Economic Policy Guidelines are drawn up annually. This document can be said to represent a common general approach to economic policy - a budget statement for the EU area.

Last but not least, there are processes for guiding countries along the road towards creating more efficient markets for goods, services, capital and labour. These are complex issues and the member states tend to differ considerably in their initial positions as well as their attitudes. But an intense dialogue has now started on structural issues at extraordinary Council meetings, such the coming meeting in Stockholm, as well as in more regular processes such as the Luxembourg process for better employment policies and the Cardiff process for more efficient product markets.

## **The EMU to date**

It must then be asked, of course, how well this framework is working now that EMU is a reality. It is certainly too early to draw definite conclusions about these matters but I can offer some observations.

The first point worth noting is that we are now reaping the benefits of the convergence process and of the consensus on stabilisation policy that has, in fact, been established. Europe is now experiencing an

economic upswing in which macroeconomic conditions are more stable and inflation expectations lower than for many decades.

Since the move to EMU, there have been no clear signs of asymmetric shocks that might hit a particular country or group of countries, although the Asian crisis and the subsequent unrest did affect the member states somewhat differently. And we do not know what would have happened during the tempestuous autumn of 1998 if Stage Three had not been well on the way. Perhaps exchange rate developments in Europe would have been considerably more dramatic and disruptive. It will be recalled that the Swedish currency's deviation from a reasonable long-term level was considerably greater than that of, for example, the Finnish markka.

Inflation's convergence in the run up to Stage Three has been checked, however, and recently the spread has even become wider. This is hardly surprising in itself, neither is it a major problem. The process known as catching up means that countries with a below-average level of prosperity initially will benefit from technological and organisational advances elsewhere and accordingly grow faster than the rich countries, which in turn can lead to higher inflation. Furthermore, countries with strong export-led growth can experience upward wage pressure in other sectors, too, leading ultimately to higher inflation. So there are reasons why growth rates as well as rates of inflation can diverge in a monetary union without this being unnatural or a problem for either the countries in question or the union as a whole.

It seems fairly evident that elements of this kind of "more innocuous" inflation are around at present. The clearest example is Ireland, with catch-up effects and a number of years of exceptional productivity growth. But even there the picture is not unambiguous and when inflation now increases in a number of member states, questions arise about the formation of stabilisation policy.

This is definitely not a problem that can be tackled with measures of monetary policy. The function of monetary policy is to maintain price stability in the union as a whole, a mandate that seems to be generally supported and understood. Neither is there any cause to criticise how monetary policy has been conducted in practice. There has been a clear endeavour to counter the upward price tendency. In my opinion, however, it would have been an advantage if management of the exchange rate had been clearly assigned to the central bank, instead of the leaving the responsibility to so many.

As regards fiscal policy, experience has not been entirely positive. As I mentioned earlier, in Stage Three of EMU the Stability Pact is monitored with annual stability programmes. This process has worked fairly well in exerting peer pressure on countries with large deficits: no country has yet exceeded the Pact's lower limit. But assessments of individual countries have tended to differ without there always being factual grounds for this. Neither has particularly good use been made of the golden opportunity that Europe's present economic upswing provides for faster budget consolidation. Countries should now be making the most of the chance of quickly turning a deficit into a surplus but that is not happening. This may prove to be unfortunate further ahead and it runs counter to the spirit of the Pact. Peer pressure has evidently not been strong enough. Examples of short-run considerations gaining the upper hand in this respect were evident when the dramatic oil price rise led several countries to cut petroleum taxes or subsidise oil-intensive industries, which is hardly sustainable in the longer run for either the economy or the environment.

Before concluding I should also like to say something about financial stability in the EU area. As I indicated earlier, EMU is leading to more integrated financial markets. In the absence of national monetary policies, this accentuates the need of joint systems and standards for financial oversight. It also increases the need of readiness for the joint management of financial crises. Work in this field is now in progress in a variety of fora.

### **Concluding remarks**

Internationalisation in general, with growth in trade and factor mobility, has brought the EU member states closer together and increased their interdependence. Politically motivated changes such as the internal market and the new monetary union have served to promote this trend.

As regards government finances, various processes, including a system of sanctions, have been set up to test national policies. This is because of the risk that individual member states would otherwise be able to pursue a policy that could harm the others. Processes have also been established in other policy areas to highlight key issues in the European debate, to point to good examples and to exert peer pressure. This should not be belittled: we know from Swedish experience that comparative analysis and in-depth debate can push things in the desired direction.

So what should we expect in the future? I have briefly touched on a number of situations where cooperation and coordination could lead to a better EU policy. However, even if there are rewards to be earned from coordination, it will probably be some time before the EU member states are sufficiently mature to take further big leaps. Ultimately it now boils down to the sensitive issue of how much power should be placed in European rather than national hands. But there is no doubting the strength of the tension between the single monetary policy and the remainder of economic policy that is still handled at national level. In this tension lies the seeds of continued economic policy coordination in Europe.