Eva Srejber: Life outside Euroland

Speech by Ms Eva Srejber, Second Deputy Governor of Sveriges Riksbank, at the annual meeting of the Economic Society, Helsinki, 11 February 2002.

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Let me begin by thanking you for the invitation to speak at the Economic Society's annual meeting.

I intend to take developments in Finland and Sweden during the 1980s and 1990s as the starting point for my talk and to illustrate the similar experiences our countries have had. After that, I shall touch on the economic arguments in favour of and against EMU membership and take up the role of the Riksbank in this debate. As the political temperature has risen in the EMU issue in Sweden, I intend to conclude with some words regarding the potential timetable.

Sometimes Finland and Sweden are compared in terms borrowed from family life or the world of sport. However, the question is not which brother or sister is the oldest, or who is ahead in the international economy race. Our countries are interwoven to such an extent today that we often go in the same direction. However, in one area our two countries have chosen – at least for the time being – to take different paths. This applies, of course, to membership of the Economic and Monetary Union (EMU). Finland has for various reasons decided to participate fully from the start, while Sweden has decided to "wait and see". At the same time, one should remember that we are still in the same economic playing field, with the same regulations and the same referee, constantly striving to make economic progress to achieve the best possible welfare – a process that actually has no end.

Similar experiences

Economic developments in Sweden during the 1980s and 1990s are very reminiscent of developments in Finland. Like Finland, Sweden underwent an overheating at the end of the 1980s, which was mainly due to an excessively high domestic demand, partly due to insufficiently tight fiscal policy, a rapid credit boom and rising asset prices in the wake of the successive deregulations - all within the framework of a fixed exchange rate regime that set limits as to how far the steering interest rate could be used to govern the level of domestic activity. The fact that Sweden and Finland did not have much to counter with when the currency crisis really got its claws into the European Exchange Rate Mechanism in 1992, should be regarded in the light of the imbalances built up within their economies over several years. It was an uneven battle, although Sweden changed its fiscal policy and the Riksbank did all it could to defend the currency, raising its steering interest rate to 500 per cent. However, Sweden was forced to abandon the fixed exchange rate as an anchor to achieve price stability in November 1992. Finland had replaced its fixed exchange rate regime earlier in the autumn.

The overheating changed into a severe setback at the beginning of the 1990s. Between 1990 and 1994 the Swedish GDP fell by a total of 4.7 per cent. In Finland the fall experienced during the same period amounted to 10.4 per cent. Finland was hard hit by the large decline in export brought about by the collapse of the then Soviet Union. Open unemployment in Sweden rapidly soared from a level of around 3 per cent in 1991 to 8.2 per cent in 1993. In Finland, the number of unemployed increased from just over 6 per cent to 16 per cent. Some of this difference can, however, be due to the slightly different form taken by labour market policy in the two countries and to how unemployment is defined. The deficit in public finances increased considerably; in Sweden it was at worst 12 per cent of GDP in 1993 and the borrowing requirement amounted to almost 17 per cent. The deficit in Finland in the same year was 7.3 per cent of GDP. The crisis in the banking system at the beginning of the 1990s hit both Swedish and Finnish banks hard.

Sveriges Riksbank, like the Bank of Finland, found itself in a difficult situation at the end of 1992, following the currency crisis. The decision on a new monetary policy strategy was taken in an environment where confidence in monetary and foreign exchange policy was low. Earlier actions in economic policy – resorting on several occasions to devaluation in the cost crises that arose – as well as losing the battle of the fixed exchange rate were some explanations for this.

Alternative strategies for finding an intermediate or direct target for monetary policy were investigated and the Riksbank studies solutions used in other countries. As in the case of Finland, we in Sweden were not used to working in an environment with a floating exchange rate. The last time Sweden had a floating exchange rate was for a few years in the 1930s. The general opinion among both politicians and economists was that a fixed exchange rate was the best solution for small, open economies that were very much dependent on other countries. This opinion has since changed – not only in Sweden and Finland, but also in many other countries.

Sweden and Finland decided on a new strategy fairly quickly and their respective central banks chose more or less the same path. Monetary policy in both countries was aimed at maintaining price stability through inflation targeting. The formulation of the Swedish objectives, as published in January 1993, was rather more detailed, as we established that CPI inflation should be limited to 2 per cent with a permitted deviation interval of +/- 1 percentage point. Finland chose to formulate its inflation target as a stable, sustainable inflation rate of 2 per cent. The two countries thus had similar ambitions. Just as in Finland, the Swedish price stability target was initially a self-imposed commitment on the part of the central bank, but afterwards it received expressed support from the Swedish parliament and government.

I shall now briefly describe developments in Sweden following the introduction of the inflation target. The Riksbank's target of an inflation rate of 2 per cent +/- 1 percentage point would apply, according to a decision by the General Council in January 1993, with effect from 1995. During the interim period from allowing the krona to float free until 1995, inflation and expectations would be brought down from the high levels that had prevailed during the 1980s. Confidence would be regained.

The Riksbank decided to publish regular Inflation Reports in order to attain greater understanding for the drawing up of our policy and the bases on which our decisions are made. The importance of transparency was reinforced in conjunction with the Riksbank being made more independent and its objectives being laid down in a special act, as of 1999. Transparency makes it easier for our employers, the Swedish parliament, to evaluate us. The Riksbank now publishes four Inflation Reports a year, where we describe clearly and in detail actual inflation trends, report the bank's assessment of the future path of inflation and draw conclusions for the direction of monetary policy. In Sweden we have also chosen to publish minutes of monetary policy discussions at our meetings and to report how the Executive Board members vote on this issue.

If we glance back in time, we can conclude that underlying inflation (UND1X) has on average remained close to the target since its introduction. Inflation also came down towards the target level much more quickly than most analysts had believed when we announced our target in January 1993. My opinion is that one factor contributing to this was the determined defence of the fixed exchange rate through both interest rate policy and through the political system rallying to show willingness to change fiscal policy to contribute to price stability. The fiscal policy consolidation implemented later during the 1990s also contributed significantly to enabling price stability to be maintained.

As the Riksbank's monetary policy is guided by the development of inflation one to two years' ahead, the inflation rate is sometimes allowed to deviate from the target in the short term. If monetary policy were aimed at continuously minimising these deviations, it could require major adjustments in the steering interest rate, which would in turn lead to large fluctuations in production and employment. This was the reason behind the decision not to try to achieve the inflation target of 2 per cent as early as 1993 and 1994. We chose instead to allow the first effect of the increase in import prices that followed in the wake of the floating krona to have an impact on the system first and to accept a temporary and limited rise in the inflation rate. What we wanted to avoid was the second round of effects. It is also for this reason that we have tolerated a 'deviation interval' since 1995.

While inflation has been low, growth in both Sweden and Finland during the inflation targeting period has been good from a historical perspective, and unemployment has fallen gradually from the high levels during the crisis years. There has been a successful consolidation of public finances in both countries and a fall in the central government debt measured as a percentage of GDP. Additionally, fiscal policy in Sweden has become more predictable with the introduction of a rolling nominal ceiling for public expenditure. Moreover, a number of measures have been taken to improve the functioning of the Swedish economy. These include deregulation and changes in the tax and social insurance systems. This has meant that the conditions for a favourable development have improved and confidence in the Swedish economy has increased.

At the end of 1996; however, Finland chose a different direction for its exchange rate policy by taking part in the ERM as a preparation for full participation in the EMU from its start in 1999, while Sweden decided in 1997 that it would 'wait and see'.

However, an unforeseen obstacle over the past decade has been the large fluctuations in the exchange rate. From an international perspective, these fluctuations have not been greater than those experienced by other countries with a floating exchange rate, but they have played a prominent role in the Swedish debate and have probably been discussed here in Finland too, bearing in mind our close trading connections.

Let me say here that while the variations in the exchange rate have been larger than we anticipated, the effects of this volatility have been much less than might have been expected. Our central bank and many others with experience of managing a small, open economy with a floating exchange rate have come to the conclusion that exchange rate fluctuations have had less effect on both prices and production; while exchange rates and import prices have varied significantly, the impact in the consumer channel has been limited.

What does the Riksbank have to say about a possible Swedish EMU membership?

Over the past six months the political temperature has risen with regard to the EMU issue in Sweden. This is possibly a reflection of the fact that the Swedish people now see membership in a slightly more positive way. It is clear that the physical introduction of banknotes and coins has made the EMU project more tangible.

The last time the Riksbank as an institution had reason to comment on the issue of whether Sweden should join the EMU or not was at the beginning of 1997 in connection with the presentation of the report by the Swedish EMU commission.[1] This commission, which was led by Professor Lars Calmfors, came to the conclusion that Sweden should postpone a possible membership. Four arguments for this standpoint were presented: *The high level of unemployment* risked becoming worse if the Swedish economy were to suffer disturbances. *The weak central government finances* comprised a restriction for fiscal policy and risked bringing about restraint in a possible economic slowdown. *Poor popular support* for membership of the union risked creating political tension. Finally, the commission made the assessment that the *EMU would initially consist of a small group of countries*, which indicated that the political costs would of not joining would not be very great.

When this was referred to the Riksbank for comment, the General Council replied that "the General Council finds that on balance Sweden should participate in the economic and monetary union from the start."[2]

The General Council played down the risks that Sweden might be exposed to economic disturbances that did not affect other members of the union, i.e. asymmetric disturbances. The General Council felt that the disturbances Sweden had experienced since the 1970s could largely be regarded as self-inflicted, mainly as a result of errors in economic policy.

One example is the economic slowdown at the beginning of the 1970s that affected Sweden more than the rest of Europe. The cause was the vigorous fiscal policy restraint brought in, which contributed to developments in Sweden coming out of synch with the rest of Europe. After that there was an attempt to "bridge over" the international economic downturn that followed in the wake of the oil crisis. The cost problem was checked by devaluation. The idea was to keep demand up until international economic activity showed an upturn.

Another example is the beginning of the 1980s, when activity in the economy once more came out of synch. Sweden came out of the decline faster than other European countries by means of two aggressive devaluations, but the cost was that inflation became stuck at a high level.

The General Council also expressed scepticism, in its comments on the commission's report, of the statement that it would be possible to pursue an individual economic policy in the case of remaining outside EMU.

With hindsight, one can perhaps conclude that this scepticism was a little exaggerated in that the steering interest rate has been both higher and lower than in the euro area in recent years and the krona has fluctuated substantially. Given that a country has systems for both fiscal policy and monetary policy that inspire confidence, there appears to be somewhat better scope for action within the framework of an economic policy aiming at macroeconomic stability than was earlier assumed.

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[1] Sweden and the EMU, SOU 1996:158.

[2] The General Council of the Riksbank's comments 1997-02-06

With regard to the labour market, it should be clear that the functioning of the labour market and the high level of unemployment no longer comprise as strong a restriction as they did in the mid-1990s. Unemployment in Sweden has fallen. Several factors have played a role in the decline. One of these is probably the fact that the wage formation system has been changed in a way that contributes to better concordance between productivity and wage growth. Nevertheless, there are clear signs that the labour market still comprises a problem area.

A clear majority of the EU member states has now joined the monetary union, which was not evident when the Calmfors Commission made its assessment. The political cost of remaining outside of EMU has thus become greater, and public opinion has become more positive towards membership.

I personally think that there are also new arguments that should be considered with regard to the costs of remaining outside the union. For instance, the economists Andrew Rose and Torsten Persson have made in-depth analyses of the effects on trade of a monetary union. There could be reason to believe that the positive effects are slightly greater than was assumed in connection with the Calmfors Commission's report. A single currency in the euro zone would remove the foreign exchange risk in around half of Sweden's foreign trade, while the other half would in this case continue with a floating exchange rate, as the euro floats against other currencies. A single currency thus provides less risk and thereby lower costs, which are most important to small companies and private persons. The larger corporations have greater capacity to manage foreign exchange risk, although they would also benefit from a lower foreign exchange risk.

What role all of these economic arguments play in the final consideration of whether Sweden should join the EMU or not depends on the weight one attaches to the economic arguments. The EMU question contains so many different dimensions that are more than the purely economic dimensions I have taken up here. A central bank can have an opinion on the economic issues, but should, in my opinion, keep a low profile in the final decision-making. It is clear in any case that Sweden has succeeded in recreating confidence in economic policy after the mistakes of the 1970s and 1980s. It is also clear that we, like other countries, need to continue to pursue an economic policy aimed at macroeconomic policy regardless of whether or not we participate fully in the third stage of EMU. It is good to be prepared for action with regard to unforeseen events – what is known as asymmetric shocks – whether we are inside the EMU or on the outside. There are several ways of achieving this both through strong public finances and a flexible economy. The Riksbank will certainly be asked to comment on the economic aspects again, particularly with regard to the commission appointed by the Swedish government to investigate the stabilisation policy consequences of EMU membership and that will soon present its conclusions. However, the final consideration of all aspects should be made at the political level. A central bank should therefore, in my opinion, avoid any statements that could be interpreted as campaigning.

The discussion of the timetable

The timetable for a potential Swedish EMU membership will be decided in the political process. The Government Bill "Sweden and the Economic and Monetary Union" from 1997 states that if the government should decide at a later date that Sweden should participate in the monetary union, the question would be put to the Swedish population for consideration. The signals from, for instance our Prime Minister Göran Persson, indicate that a referendum could be held next year. Other political leaders appear to be thinking along the same lines. If the result were to be a "yes", Sweden would present an application to the EU Commission and the ECB for an examination of whether we fulfil the legal and economic convergence criteria for inflation rate, long-term interest rates, exchange rate stability as well as the budget level and the public sector debt.

If Sweden is accepted as a member, there would then be a negotiation regarding the Swedish transition process; when membership would occur, what rate the SEK/EUR exchange rate would be fixed at, how long the transition and currency changeover periods would be, etc. To enable a rapid entry process, the Swedish parliament decided back in 1997 that Sweden should maintain the highest possible level of preparedness by continuing technical and practical preparations. The Riksbank has therefore been working together with the financial sector for the past five years on preparing for a possible future membership. This work is led by the SIFS Group (Consultation and Information within the Financial Sector) and the seventh situation report was completed in the autumn and is available for perusal on our website.

We can conclude that since the euro was introduced as an electronic currency in the euro zone on 1 January 1999, the Swedish financial sector has offered a number of services in euro, e.g. payments, deposit and lending services as well as share trading. However, considerable efforts are still required to prepare the sector for a possible membership. These include extensive work to change over data and accounting systems that are currently set to kronor as the reference currency to euro. This is in order to achieve a properly functioning financial infrastructure in euro from the first day of EMU membership. The most recent situation report describes two transition scenarios; one gradual scenario and one that is termed Big Bang. A gradual transition requires, as you here in Finland are well aware, that the exchange rate is fixed irreversibly from the date of joining the union and the euro becomes the national currency, while banknotes and coins in the old currency continue to remain legal tender during a transition period. During this period there is no compulsion to use the euro and nor is there any prohibition against it. The disadvantage of a gradual transition would be that, as euro banknotes and coins already exist in the euro zone, it may appear strange to the Swedish general public that they cannot use them fully in all transactions in Sweden right from the start. The advantages of a gradual transition are that the major technical and practical adaptations to the euro could be made in stages, while Sweden would be able to participate fully in all co-operation and decision-making forums in the euro zone from EMU membership, without having to wait until the practical work was finished.

The most recent report states that in a gradual transition process the financial sector and central government sector would need 1-1.5 years from the time of a political decision until the SEK/EUR exchange rate was fixed in order to prepare. After this, a further one year would be needed for the financial sector and two years for the central government sector before euro banknotes and coins could replace the krona. This is 1-2 years shorter than the three years the current EMU countries have had to prepare. It would mean in total approximately 2-3 years from a referendum until the euro were introduced completely. However, I believe that this preparation time can be shortened somewhat, assuming that the political process is open and establishes a clear timetable and that a transition process is chosen. It is worth remembering that there is nothing to say that EMU membership or a currency changeover should take place at the start of a year. For practical reasons it might be better to introduce the currency changeover in particular in, say, March or October.

Another alternative described in the report is what is known as Big Bang, i.e. to begin the currency changeover at the same time as the krona exchange rate is fixed and membership of the third stage of the EMU takes place. This scenario would require a preparation period of 2-2.5 years. It would require that the euro could be processed in all transactions in Sweden, both physical and electronic, and by everyone in Sweden, from the local tobacconist to the Swedish national social insurance board and the major banks, right form day one. As this alternative at the same time requires a changeover in IT systems, other practical items such as accounting, tax payments and a physical currency changeover, it makes great demands for co-ordination and information. Bearing in mind the longer preparation period prior to actual EMU membership required in this alternative, it would actually take longer until Sweden could fully participate in all co-operation and decision-making forums in Euroland than would a gradual transition process. The advantage with this scenario is that there does not need to arise any uncertainty among the general public with regard to the position of the euro during the transition period, in that the euro could be used everywhere right from the start.

We must therefore consider carefully what form a Swedish transition scenario should take, even if the discussions have generally favoured a gradual process. Here, Finland's experiences could certainly be of great value to us in the Swedish preparation work.

Conclusions

Regardless of whether or not Sweden chooses to take the same path as Finland and join the EMU, it is important to maintain a high level of ambition with regard to keeping our public finances in good condition, maintaining price stability and creating the right conditions for a good growth in productivity. This creates freedom of action, regardless of whether or not we join the union. There are both advantages and disadvantages in remaining outside. However, the question will not be determined merely by economic arguments, it is more a case of political arguments. It is important to remember this.