

Lars Heikensten: The Riksbank and the euro

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at the SEB's EMU seminar, Cirkus, Stockholm, 4 September 2003.

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Let me begin by thanking the organisers for inviting me to speak at this event.

The past few months have certainly been hectic for those of us working at the Riksbank. We are undoubtedly in the eye of the storm and feature almost daily in the EMU debate. Moreover, we are affected more directly and tangibly by the result of the referendum than most people. I can take my own diary as an example; if the result is a "yes" vote, I will be in Frankfurt for a day or two at least every other week, while if the result is a "no", the visits will be reduced to a few hours four times a year.

Given this, the temptation to jump into the debate head first has been strong at times. However, we have decided not to participate in any campaigns. The Riksbank as an institution took a stand in favour of EMU membership in the form of submission responses in both 1994 and 1997. However, the Executive Board has now decided to refrain from taking a stand in connection with the referendum. The personal views of the various members of the Executive Board have nevertheless been known for some time. Five of us are in favour, one against. As the staff of the Riksbank has knowledge and experience of significance in this field we have agreed to contribute factual information. We have also agreed that any senior managers wishing to express their views on various issues relating to the EMU discussion may do so, as long as this is done in a factual manner. Our ambition here is of course to ensure that the general public retains confidence in the Riksbank regardless of the outcome of the referendum.

Today I intend to briefly discuss three issues that have arisen in the discussions and of which the Riksbank has knowledge and experience. The first concerns whether the differences between the ECB and the Riksbank are as large as is sometimes claimed. The second issue is the need for a national stabilisation policy. Finally, I shall discuss, on the basis of our own experiences, the conditions for influence in economic policy forums if we choose to remain outside the Eurosystem.

Are there major differences between the Riksbank and the ECB?

In Sweden we lived for a long time - rather longer than the core EMU countries - under the impression that better economic growth and lower unemployment could be achieved merely by allowing inflation to be slightly higher. This led to repeated devaluations and to much poorer economic growth. Sweden fell behind the other EU countries in terms of GDP per capita and purchasing power. There was a break in this policy at the beginning of the 1990s, in connection with the crisis during that period. Importing the stability-oriented policy that had long been conducted in the EMU's core countries helped to create better conditions for future growth.

The policy model we now follow comes originally from Germany. During the entire post-war period they have endeavoured, to a great extent successfully, to maintain price stability. The task of achieving this has fallen to the German central bank - the Bundesbank - which has operated independently, at arm's length from party politics.

The Bundesbank model is now copied by a number of industrial nations, which have given their central banks a large degree of independence and the task of aiming for price stability. This policy is also reflected in the Maastricht Treaty and in the Riksbank legislation. My colleagues in the major industrial nations also try - as long as they are sure that inflation is not about to deviate from the desired level - to take account of economic activity and unemployment. There are thus considerable similarities and this applies not only in Europe, but also in a comparison with, for instance, the US, although the stipulated targets vary, sometimes for historical reasons. In this sense we are all the children of the Bundesbank!

Within the central bank world the methods of working have also become more similar in recent years. Although not all industrial nations with a floating exchange rate say that they use inflation targeting, they actually do so in some form. All of them apply a forward-looking perspective; they produce forecasts and try to adapt interest rates in good time to ensure that inflation will be in line with a target

that is formulated with varying precision. The ECB now says that inflation should be below, but close to, 2 per cent, which does not differ greatly from our symmetrical 2 per cent target, given the prevailing error margins. In addition, we usually say that we focus on inflation 1-2 years ahead, while the ECB says it applies a medium-term perspective. There is no great difference here, either.

When it comes to communication and accountability, the similarities also outweigh the differences now. This is perhaps not so surprising. Greater independence leads to a natural increase in demands for central banks to clearly explain and account for their actions. It is also natural that it should be possible to assess these actions. To this end, those who appoint the Executive Board at the Riksbank and at the ECB have the opportunity to attend important board meetings. Both institutions are also accountable to their respective parliaments. However, there are also a number of differences. For instance, our target is more precise and we regularly publish inflation reports containing forecasts that show how our analysis work develops and changes over time. We also publish separate minutes of our monetary policy discussions.

Neither monetary policy theory, nor its practical implication is written in stone. Changes occur over time. In this spirit the ECB has been reviewing its monetary policy operations over the past year. The enlargement eastwards will entail a new, formative stage. I would gladly work actively to achieve increased clarity and transparency within the ECB if the result of the referendum is a "yes" vote.

Is a national stabilisation policy necessary?

The risk that Sweden could end up in a different situation from the rest of the euro area, and that this would cause serious economic policy problems, has been strongly highlighted in the Swedish discussions, much more so than in other countries where the monetary union has been discussed. The reason for this is, of course, the severe crisis that occurred at the beginning of the 1990s, with the collapse of the krona in 1992, which had such a tangible effect on the lives of many in Sweden.

In my opinion, there is a tendency to overestimate the risks that developments in Sweden will differ substantially from the rest of the world and require unique stabilisation policy measures. When we have differed from other countries previously - such as during the crisis years of the early 1990s - this has usually been the result of conducting a different economic policy; of not having control over inflation or focussing on stability, as the core EMU countries did. However, there now appears to be a consensus that economic policy should be aimed at long-term stability and that this policy should stand firm.

At the same time, I do not think that a relatively similar development in interest rates in Sweden and the euro area in recent years is sufficient argument against the need for a national stabilisation policy. While it is true that the instrumental rates have developed similarly to one another, which I believe will also be the case if we remain outside the Eurosystem, the point of a national stabilisation policy is not to fine-tune a relatively normal level of economic activity, as we have experienced in recent years, but to manage situations where Sweden for some reason deviates from the course pursued by the rest of Europe. Such a situation cannot be completely ruled out.

The task we face if the result of the referendum is a "yes" vote is to make use both of other countries' experiences and our own from the past ten years and to translate these into an appropriate regulatory framework for fiscal policy. The changes in budget policy, with a long-term expenditure ceiling and a budget surplus target, form a natural starting point. It is quite simple. There should be sufficient reserves for the central government to be able to bear a deficit for a period if the economy were to deviate significantly. This requires first and foremost that the central government debt be further amortised, which is a desirable goal in any case. If these reserves are available, one can be fairly sure that they will be used in a crisis situation. The opposite situation is more difficult; when restraint is required in situations where there is a risk that prices and wage formation could get out of control. It would then be necessary to find institutional solutions to help the government and parliament to make the necessary long-term decisions and to do so even in situations where they may be politically difficult and even risky. Here I think it is possible to draw on some experiences of the Riksbank's actions in recent years. Clear targets, transparent analyses and discussions, combined with regular assessments, can put pressure on the political system to take action in time. If you remember, there was doubt at the beginning that the Riksbank would be able to achieve its inflation target.

Some people say it is an impossible task. That Swedish politicians will never be able to manage fiscal policy in a responsible manner. I find this rather difficult to understand, although we have negative experiences from the 1970s and 1980s. It is enough to look at two of our three closest neighbours -

Denmark and Finland. Both have experienced equally severe fiscal policy problems as Sweden, but they now have, as far as one can see, fully-functional fiscal policy regimes adapted to fixed exchange rates. A different, improved budget policy system was also established in Sweden following the crisis in the early 1990s, although this was aimed at long-term sustainability rather than stabilisation, which is only natural with a floating exchange rate.

Is EMU membership important for Sweden to gain influence?

Finally, I intend to discuss what I personally consider to be the most important aspect of the EMU issue - how Sweden's opportunity to take responsibility and exercise influence in an international economic policy context will be affected by the result of the referendum. Here I am speaking not primarily as Riksbank governor of six months but on the basis of my experiences over almost 20 years, as civil servant in the Ministry of Finance under three finance ministers and later as deputy governor of the Riksbank, representing Sweden in numerous international forums.

My first reflection concerns Sweden's influence now, compared with before. As I see it, Sweden's influence has declined considerably, which is not always made clear in the general debate.

The most important reason for this erosion of Sweden's position is that we, as I mentioned earlier, have declined in economic strength in relation to almost all of the other industrial nations. In addition, there is a more positive aspect here, namely that a number of former developing countries have made considerable economic progress and are now important players in the international economic policy game. The result is that we now sit at fewer decision-making tables than at any other point during the post-war period and we carry less weight at those tables where we have retained a place. One expression of this is that an ever-declining number of Swedes now hold central positions in economic policy and financial contexts. We have come a long way from the time when the first two heads of the IMF were Swedes. It is against this background - our weaker international position - that we should evaluate the importance of becoming full members of the European cooperation.

Globalisation has strengthened the significance of the European Union. Of course, I can make direct contacts and conduct a dialogue with my colleagues in, for instance, South Africa or Argentina, and argue for a particular line in an international economic policy issue, which I actually often do. They listen to my arguments, but when it really comes to the crunch on an important and sensitive issue, they always wonder what Europe thinks. To an increasing extent - and here there is a tangible difference compared with ten years ago - countries in other parts of the world are regarding Europe as a whole unit. Thus, if we do not have a strong influence in Europe, we will not be heard very far.

The discussion of influence focuses too much, in my opinion, on the value of sitting on the ECB's Governing Council and determining interest rates. Of course, as members we would do all we could to ensure this functioned well, but there is no opportunity here to take into account specific Swedish interests; the rates are set for to the good of Europe as a whole. More important from a Swedish perspective would be the discussions on developments in and regulation of the financial system. As banks and securities markets become increasingly integrated, new and interesting questions arise with regard to the best means of exercising international supervision and oversight. Plans are also being drafted for the European payment system. The ECB plays a central role in this work. Whether or not we have a place at the decision-making table affects the conditions for the financial sector in Sweden, a sector that currently employs around 80,000 people, which is almost twice as many as, for instance, the forestry-based industries.

Even more important here is the broader economic policy decision-making, primarily through the Ecofin Council, where the Ministers of Finance meet regularly. The trend is clear, although the changes have so far been tentative and gradual. An increasing number of the important issues are discussed and decided in practice in the small circle of countries participating in the Eurosystem, what is known as the Euro group.

It is not difficult for me to point out issues from recent years where we could probably have exerted greater influence if we had been members. During the early years, when the ECB was being built up, we sat at the decision-making table. When it then became clear that we and the Brits intended to remain on one side, our colleagues quite simply decided to postpone a number of important issues where we had strong views, including the monetary policy framework with inflation targeting, transparency, etc. This also applied to various payment system issues, where our position was weaker on the outside.

We have thus already lost considerable influence, which is also confirmed in surveys. If we now say “no” to membership, if not for good but at least for the foreseeable future, the situation will worsen further. The fact that we were fully engaged in the work on preparing for the EMU in the mid-1990s means that we have good personal contacts, which are valuable in particular during difficult crisis and negotiating situations. A new generation of decision-makers, with whom we do not have the same relationship, will gradually enter the system. The allowances made by many countries and colleagues while expecting that we would soon join will no longer be made. The EU enlargement eastwards will also increase the group of countries involved and we will become less interesting. In addition, we will miss a formative stage in connection with the enlargement. Once it has been completed, the situation will in many ways be more fixed.

Conclusion

I have discussed in my talk three questions that have arisen in the EMU debate. All three are connected in some way to the operations of the Riksbank. A brief summary of my conclusions is:

- The European Central Bank is sometimes depicted as an institution completely different from the Riksbank. I think this is wrong. Of course there are some differences in working methods, although these have declined recently. However, the similarities in the policy pursued are much greater than the differences. We are both children of the successful German central bank, the Bundesbank. We have sprung from the same intellectual model, where the target is price stability, the management are appointed by the political system and the actual work is done at an arm's length from party politics.
- In my opinion, the value of conducting a national interest rate and exchange rate policy is exaggerated in the EMU debate. On the other hand, it is conceivable that situations might arise where strongly stabilising fiscal policy measures are necessary. It would then be necessary to find institutional solutions to help the government and parliament to make the necessary long-term decisions and to do so even in situations where they may be politically difficult and even risky. Here I think it is possible to draw on some experiences of the Riksbank's actions in recent years. Clear targets, transparent analyses and discussions, combined with regular assessments, can put pressure on the political system to take action in time.
- As representative of the Riksbank, I have been able to experience at first hand the closed doors to the meeting rooms of Europe and the fact that we have lost influence. During the early years, when the ECB was being built up, we sat at the decision-making table. When it then became clear that we and the Brits intended to remain on one side, our colleagues quite simply decided to postpone a number of important issues where we had strong views, including the monetary policy framework with inflation targeting, transparency, etc. This also applied to various payment system issues, where our position was weaker on the outside. If we now say “no” to membership, if not for good but at least for the foreseeable future, the situation will worsen further, as I have described already. I think this would be very unfortunate.