Mr. Heikensten discusses economic policy in EMU and Sweden Speech by the Deputy Governor of the Bank of Sweden, Mr. Lars Heikensten, at an IIR Seminar on “EMU soon a reality - how is monetary policy affected?” in Stockholm on 12/2/98.

1. Introduction

The European Monetary Union is now less than a year away. For Europe this is a momentous step, perhaps the most important change, after the fall of the Iron Curtain, since World War Two. EMU will gradually entail major consequences for European economic development, for the way in which monetary policy in Europe is conducted, for financial markets and for all European citizens.

Today I shall mainly be considering three issues:

- First there is the countdown in Europe. Which decisions about EMU and monetary policy will have to be made in Europe in the coming year?
- Then I shall say something about the problems that European economic policies will encounter. How, for example, should fiscal and monetary policies be constructed? What will be the need for cooperation and dialogue?
- Finally some words about the economic policy issues that will be raised for Europe and for Sweden.

2. The countdown in Europe

Timetable for spring 1998

Perhaps the principle issue this spring is, of course, which countries will be adopting the euro from the start. The selection process starts at the end of February when the member states submit national convergence data. What has happened in the past year with budget deficits, government debt, inflation and interest rates, for example? The European Monetary Institute and the Commission will then independently assess the national statistics in the light of the Maastricht Treaty’s criteria. The findings are to be presented in two convergence reports on March 25th. On the same day, moreover, the Commission is to present a recommendation to the Ecofin Council as to the countries that meet the necessary conditions for adopting the single currency, as well as a recommendation concerning countries that are considered to have an excessive government deficit.

The reports are to provide a basis for decisions by the Heads of State or Government and show whether members states are ready to adopt the single currency – whether they have achieved what is commonly referred to as sustainable economic convergence, though what is meant by sustainable is not clearly defined in the Treaty. The convergence reports are also to assess whether member states have adapted their national laws in accordance with the Treaty and given their central bank an independent status with price stability as the statutory objective.

During March and April these reports and recommendations will be studied by the member states and the EU institutions. During the first weekend in May, which is liable to **be hectic, the final decision will then be taken.**

The Ecofin Council will convene in the evening of 1st May to discuss the reports and the Commission’s recommendation before drawing up a recommendation to the Heads of State or Government as to which member states fulfil the necessary conditions for the adoption of the single currency. The recommendation from the Ecofin Council is also to be presented to the European Parliament, which will then forward its opinion in the morning of 2nd May so that this, too, can be taken into account in the decision by the Heads of State or Government. That afternoon, finally, the

Heads of State or Government of the member states will assemble to make the final decision, which requires a qualified majority, about which countries will adopt the single currency from the start in 1999.

As soon as it has been decided which countries will be participating in the euro area, the Ministers of Finance or Economic Affairs in the selected countries will meet to decide the bilateral exchange rates between their national currencies that will apply from 1st January 1999.

At the same meeting, the ministers of the selected countries will prepare a recommendation concerning the future members of the Executive Board of the new European Central Bank (ECB). Work on this is already in progress and, as you will have gathered from discussions in the press, arriving at an agreement is not a simple matter. There are some general criteria to do with professional experience and so on but in practice it is almost inevitable that nationality will also be a criterion. During May and June, both the European Parliament and the EMI will express an opinion on this recommendation. The composition of the Executive Board is to be finally decided by the Heads of State or Government by 1st July at the latest. This decision must be unanimous.

New central bank established

Once the ECB's Executive Board has been appointed, work can start on building up the new organisation. The *Executive Board* is to comprise a president (the head of the ECB), a vice-president and up to four other members. If some member states do not adopt the euro from the start, it is possible to appoint a smaller Board and enlarge it later as more states join; but the Board must consist initially of at least four members. The term of office is eight years. When the members are first appointed in 1998, however, their terms will differ so as to avoid having to renew the whole Board simultaneously.

The Executive Board and the central bank governors of countries that adopt the euro constitute the ECB's highest decision-making body, the *ECB Governing Council*, which is to meet at least ten times a year. Monetary policy decisions require a simple majority; each member has one vote and the president has the casting vote.

The Executive Board is to conduct monetary policy in accordance with decisions and guidelines from the ECB Governing Council. But rather than concentrate everything in Frankfurt, the intention is to arrange for the national central banks (NCBs) to undertake as much as possible, including monetary policy's implementation. The Executive Board will accordingly issue the instructions that the participating NCBs need in order to carry out the decisions. The Executive Board will also be accountable for the day-to-day activities of the ECB.

The central bank governors of member states that do not adopt the euro, e.g. Sweden, will be represented on the *ECB General Council* together with their colleagues from participating countries and the ECB president and vice-president. The General Council is the ECB's third decision-making body but will not exert any influence on the single monetary policy; it is intended to take over the functions that are currently performed by the EMI. The General Council will exist as long as there are member states outside the euro area. Information about decisions taken by the ECB Governing Council will be conveyed to central bank governors of outsider countries via the General Council.

These three decision-making bodies will presumably be supplemented with committees with representatives of the NCBs, along the lines of the EMI's existing committees. The structure of this has still to be decided. There are likely to be committees for discussions on monetary policy, payment systems, inflation forecasts and so on. Neither is it yet clear in which fields and to what extent outsider countries will be able to participate in this committee work.

The ECB will not be a large organisation. To begin with, around 500 people will work centrally in Frankfurt, about 400 of them as administrative staff. There will clearly be a great deal of discussion about how the work should be divided between the ECB and the NCBs. The ECB is naturally interested in creating a strong and highly competent central organisation that can uphold an overall European perspective in monetary policy. At the same time, many of the participating countries are interested in maintaining competence, operations and influence. One aspect of this that is already colouring some discussions is the effects that different ways of organising the central bank activities would have on the geographical distribution of private financial activities in the Union. What consequences would, for instance, a decentralised implementation of monetary policy have for the status of Frankfurt relative to Paris or London?

Most issues resolved

The work of constructing the new European Central Bank (ECB) and the European System of Central Banks (ESCB) has been in progress for a long time. It is now more than four years since the NCBs joined forces to lay the foundation for a new central bank. To appreciate what this entails it is necessary to look at what the new central bank will be doing.

The Treaty states that the ESCB is to define and implement the monetary policy of the Community, conduct foreign exchange operations, hold and manage the official foreign exchange reserves of the member states and promote the smooth operation of payment systems. In addition, the ESCB is to ensure that supervisory authorities can pursue their policies and thereby contribute to the stability of the financial system.

While the NCBs will play an active part in the implementation of monetary policy, it is the ECB that will prepare and make the policy decisions. The ECB accordingly needs its own analytical capability for the work of constructing monetary policy and deciding the appropriate level of the interest rate. This in turn calls for a *monetary policy model* and a strategy for constructing the policy so that the ultimate objective is met. When the interest rate has been set, a *system* is needed whereby the central banks can exercise *interest rate control* and signal their intentions clearly. An effective monetary policy also requires a *system for payments and the exchange of information* between the central banks as well as with the financial sector. Certain *financial market procedures* have to be harmonised and uniform principles have to be agreed; for example, securities issued anywhere in the euro area must be eligible as collateral. Then the ECB has to have *foreign reserves* as well as routines for their management. The matter of *accounting* also has to be settled. In the context of information and analysis, moreover, there will have to be harmonised *statistics* for the euro area. The organisation and administration of the new central bank then have to be arranged. Premises, personnel and equipment must be ready for the ECB to function as of January 1999.

Most of these issues have been resolved through the EMI cooperation, though of course this has not always been simple. The Community consists of fifteen sovereign states with traditions that differ in many respects and affect how a central bank works. This is not just a matter of attitudes to monetary policy and inflation; it also concerns approaches to regulations, free trade, administrative traditions, transparency and so on. Each NCB has a veto, so the discussions have been lengthy. But the main features of the system are now clear, as are the principles that will apply.

There are some issues, however, that could not be solved in the EMI, so the matter has been referred to the ECB. In such cases, alternative solutions have been prepared and their number has been reduced as far as possible to make it easier to reach the final decision.

1. The choice of *monetary policy strategy* is one matter that has been referred to the ECB. The primary objective – price stability – is stipulated in the Treaty but it will be up to the ECB

to quantify this objective, make it operational and choose the strategy for achieving it. To prepare for the ECB’s decision, the EMI has studied alternative strategies and whittled these down to two: a direct inflation target and an intermediate target in the form of a monetary variable.

2. The EMI is setting up TARGET, a European payment system or a freeway for intra-EU payments. All the NCBs are developing their national payment systems for real-time settlement and linkage to a common network. A matter of importance for Sweden that has not been settled is whether non-euro countries will have access to *credits in the payment system*. Some countries fear that if they do, it may be detrimental to the single monetary policy. The Swedish position, however, is that member states outside the euro area ought to have access to intraday credit on the same terms as euro participants. TARGET will not be the only payment system in Europe and will have to compete by being the most efficient and reliable. A smooth flow of payments in the system would accordingly benefit all the participants.

3. The principles for the new system for interest rate control are known; the system will resemble the Swedish arrangement with an interest rate corridor and a repo rate. But the ECB will also have to decide whether the monetary policy instruments are to include minimum reserves. Those in favour argue that minimum reserves facilitate the construction of monetary policy, for instance by reducing the need to fine-tune liquidity. In Sweden, however, we consider that minimum reserves create unnecessary complications and are not required for controlling liquidity.

3. Economic policy in EMU

With all the preparations completed, the monetary union can be established on 1st January 1999. There will be a single monetary and exchange rate policy – that is inherent in the notion of a monetary union – but fiscal policy will continue to be conducted nationally. But the situation will be new for both fiscal and monetary policy; credibility must be established under the new conditions and ways must be found for cooperating on the different components of economic policy.

Monetary policy

The ESCB will have a very independent status so that monetary policy can focus on sustainable price stability and be immune to short-run political considerations. The national governments have enshrined these principles in the Maastricht Treaty, which every member state has ratified.

Independence, however, does not absolve the ECB from the duty of explaining its policy in public. It is rather the case that just the high degree of independence, plus the fact that the ECB is a new institution with no store of credibility on which to draw, obliges the new central bank to be particularly transparent. If the single monetary policy is not made comprehensible to the public and politicians, the ECB will not acquire the desired credibility.

A clear strategy for the single monetary policy is therefore needed. The Riksbank considers that the strategy should include a distinct and explicit inflation target. One advantage is that such a target is comparatively easy to explain and monitor. We have also argued that inflation reports should be published on a regular basis in order to provide as transparent a picture as possible of the current policy and how this will be constructed in the future against the background of the existing forecasts.

Opinions on this matter differ, however. Monetary targets are likewise distinct in the sense that they can be monitored for fulfilment. But they do not always show a direct relationship with inflation and in practice they may have to be abandoned from time to time. That is liable to render the policy less transparent.

Without being unduly partial, it seems to me that the Swedish arrangement with an inflation target is attracting growing attention. It is strongly supported by academic economists and my European colleagues are also increasingly interested in our experience. But against this there is, of course, the Bundesbank's long and favourable experience of monetary targeting and Germany's self-evident weight in this discussion.

Certain routines for the central bank's policy presentation are prescribed in the Treaty. The annual report from the ECB is to be presented to the Ecofin Council and the European Parliament, which may hold a general debate on that basis. The ECB president and other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the Parliament's committees. EU discussions are in progress on the arrangements for this and whether further clarification is feasible.

Under the Treaty, meetings of the ECB's Governing Council may be attended by the president of the Ecofin Council and a member of the Commission but without the right to vote. Similarly, the ECB president may attend Ecofin Council meetings on matters relating to the ECB's objectives and tasks. The Ecofin Council president is also entitled to submit motions for deliberation to the ECB Governing Council.

Exchange rate policy in the monetary union is another topic for discussion. This is hardly surprising – interest rate policy and exchange rate policy are two sides of the same coin. An interest rate adjustment, upwards or downwards, normally affects the exchange rate, just as the exchange rate has consequences for inflation and thus for the appropriate level of the interest rate. The Treaty entitles the European Council to issue guidelines for exchange rate policy under a flexible exchange rate between the euro and other currencies. Discussions have been held to clarify what this entails. The member states have agreed that such guidelines are to be drawn up only under exceptional circumstances and then only in general terms. The guidelines are not to jeopardise the price stability target. Still, it is not entirely clear how exchange rate policy will be implemented.

Fiscal policy

Fiscal policy will continue to be a national concern in EMU. The Maastricht Treaty is intended to institute a common objective to preclude imbalances in government finances. This objective is specified in greater detail in the Stability and Growth Pact that the member states concluded last year, the aim being to avoid fiscal irresponsibility in member states after the move to Stage Three.

In this Pact, all the EU countries have undertaken to avoid an excessive government deficit and to aim for a budget that is close to balance or surplus in the medium term. In principle, a budget deficit is not to exceed 3 per cent of GDP. A country in the euro area that exceeds this limit will normally be liable to a fine. Sanctions can be waived, however, under certain exceptional circumstances defined by the member states.

The reasonableness of the Pact's strict limit for government finances has been discussed and doubts have been expressed as to whether fines can be imposed in practice. The monetary union accentuates the need to adjust Europe's economies in other ways than via the exchange rate, above all as regards the functioning of the labour market. But national fiscal policy can provide a buffer in the event of shocks. Provided the medium-term objective is met, moreover, there is still some scope for fiscal policy under the Pact.

Estimates from the OECD and others indicate that, as an average for the EU countries, a retardation of growth by one percentage point enlarges the budget deficit relative to GDP by half a percentage point. This implies that a normal conjunctural slowdown can cause the cyclical deficit to increase by about 1–1.5 percentage points. Staying below the ceiling imposed by the Stability Pact then presupposes a limited structural deficit. Today the statistical picture is troublesome in that a number of member states, including some of the core countries, have structural deficits of more than 2 per cent. This leaves a very small margin for coping with an economic slowdown.

Trade-off between fiscal and monetary policy

The credibility and success of the Stability and Growth Pact are highly dependent on the ability of member states to meet the medium-term target. Like the single monetary policy, under the Pact fiscal policies will be closely scrutinised and assessed in the initial years. For monetary policy, high credibility confers greater freedom to make temporary allowance for other factors without this impairing expectations about the central bank’s target. Similarly, by building up credibility, more room is created for the Ministers of Economic Affairs or Finance to accept minor deviations from the Pact.

Monetary policy and the other components of economic policy are interdependent. Safeguarding price stability, for example, is easier if fiscal policy is tight and Europe’s economic structures function smoothly. From time to time there may be more direct calls for a dialogue about policy but such a dialogue must not be allowed to endanger the price stability objective; neither need it, since the ECB ultimately controls the instruments whereby low inflation can be maintained.

Let me illustrate this with a simple example. About a year ago most economists considered that British policy needed to be tightened to prevent inflation from exceeding the targeted rate. However, the pound was already so strong that most people believed British manufacturing would ultimately suffer. If possible, therefore, it was fiscal policy that should be tightened. As things turned out, however, the adjustment was made via monetary policy. The Bank of England lived up to its responsibility for price stability and raised the interest rate to prevent an increase in inflation.

Precisely the same discussion may be called for in the future at the European level. The ECB may perceive a threat to price stability even though the euro is “too strong” and may therefore advocate fiscal restrictions. The finance ministers in turn may want to discuss how this should be done and how the burden of adjustment should be allocated between them. Such matters are far from simple; I mention them here mainly to illustrate what I see as a growing need for communication and cooperation, at least if the aim is to construct policy with the best interests of Europe in mind.

As most of you know, a dialogue and cooperation have been called for in the debate on the monetary union’s policy arrangements. In December 1997 the member states agreed on the setting up of what has been called the Euro X Council. This body is not to have any formal decision-making powers and its composition is to be determined by the agenda. Matters that only concern countries in the euro area are to be discussed by the ministers of those countries; representatives of the outsider countries may join in on matters that are also of interest to them. How participation in Euro X is to be decided and the arrangements for this are not yet clear. What is clear is that the Ecofin Council is the only decision-making body and that all formal decisions have to be made there.

In my opinion the debate about Euro X tended to extremes. It can hardly be denied that in certain economic matters the euro participants will need to arrive at a common standpoint. The above example of the United Kingdom is a case in point. At the same time, the mutual dependence of countries inside and outside the euro area is very pronounced and good arguments for excluding outsider countries from the discussion are to be found in extremely few issues (one example is perhaps matters to do with the position of the euro relative to the currencies of non-euro member states). A number of colleagues have in fact indicated some concern about the EU split that Euro X might bring about under unfortunate circumstances.

4. Economic policy in Sweden

It is frequently claimed that the establishment of a European monetary union that Sweden has chosen not to join imposes new requirements on Swedish economic policy. This may be true but only up to a point. EMU will bring the countries of Europe closer to each other economically and this will accelerate and accentuate the internationalisation of Sweden's economy. The consequences are essentially favourable: stronger competition and lower prices, access to a larger labour market, etc. At the same time, in some respects internationalisation restricts the scope for national economic policy. But in this context EMU does not represent something radically different; it simply reinforces earlier tendencies.

As regards economic policy, the major step was really taken at the beginning of this decade with the realignment of our policy for stability. Today, the main features of Swedish economic policy are the same as EU policy and there are good grounds for believing that this will continue to be the case. Here I shall briefly consider three types of argument:

- Firstly, the results of policy in recent years; low inflation and a rapid improvement in government finances.
- Secondly, institutional changes; the rules for both monetary and fiscal policy have been changed so that conditions today for conducting a policy for stability are considerably better than before.
- Thirdly, Sweden, whether or not we adopt the single currency, belongs in a European context that will continue to exert a distinct pressure on our economic policy and markedly affect our freedom of action.

Good results for growth and inflation

The 1990 Budget Statement contained the first clear statement that low inflation was one of economic policy's primary objectives: low inflation paves the way for future growth and employment. The distinct message signalled an awareness that there was no turning back – the devaluation policy was no longer tenable and what mattered now was a policy focus on long-term stability. This awareness naturally had its roots in the Swedish experience of recent decades – a combination of high inflation and weak economic growth. But another important contribution was the EU experience – in many countries a policy focused on low inflation since the early 1980s had borne fruit, for instance in terms of growth. A major drawback, however, was that the good growth had not generated good results in terms of employment. After the fall of the Iron Curtain, Sweden was now beginning to draw closer to the EU politically.

Since the reduction of inflation to a more normal European level, which happened soon after the policy realignment, the rate of price increases in Sweden has matched or been below the EU average. Since the announcement of the inflation target in January 1993, the CPI has risen at an average annual rate of 2.3 per cent. Since the target came into force at the beginning of 1995, CPI inflation has averaged 1.5 per cent. The picture is even clearer in terms of underlying inflation, calculated to exclude transitory effects like tax increases, interest rate adjustments, etc. This indicator of inflation has been relatively stable inside the tolerance interval of 1–3 per cent that surrounds the Riksbank's target.

It is worth underscoring that the economic growth which has accompanied this performance has been relatively good. Since the low in economic activity in Sweden in the summer of 1993, at 2.5–3 per cent the average annual GDP growth rate has been higher than in the 1980s. However, employment has not picked up with growth to the desired extent. This has to do with numerous factors, of which one is, of course, the cuts in public sector activities in connection with budget consolidation, for example. Another factor is the problems in the labour market, which partly concern rules and the process of wage formation.

The profound crisis in the early 1990s meant that output in Sweden dropped by around 5 per cent, which is almost unparalleled in post-war Europe. The drop in production was the primary cause of the dramatic weakening of government finances in the period 1991–94. Since then this situation has also radically improved. Having peaked at over 12 per cent of GDP, the government deficit has swung sharply. Stronger economic activity has made a major contribution to this but it would not have been possible without the extensive consolidation of government finances. Tax increases and spending cuts between 1995 and 1997 have totalled the equivalent of almost 7 per cent of GDP. Besides their direct budgetary impact, these measures laid a foundation for a downward shift in interest rates, a considerably better exchange rate trend and an overall economic stabilisation that aided the improvement appreciably.

The massive budget deficits meant that in the period 1990–96 public sector debt grew from 44 to 78 per cent of GDP. This restricts the future freedom of action in fiscal policy. For Sweden this constraint is accentuated in that the high revenue and expenditure ratios render the budget very susceptible to conjunctural factors. Seen in this light, the Government’s objective of a 2 per cent budget surplus over the medium term seems reasonable. It also provides a margin of safety for the deficit criterion in the Stability and Growth Pact. A budget surplus lessens the risk of a sizeable deficit when economic activity is weak. Moreover, the objective means that Sweden fulfils the undertaking in the Pact that the budget is to be close to balance or in surplus in the medium term.

Institutional changes

To some extent, Sweden’s problems with government finances have stemmed from institutional factors. In recent years, however, there have been changes which improve the conditions for a sound budget policy. One change, instituted for other purposes as well, is that the Riksdag is now elected for four years instead of three; the longer mandate renders policy more stable. As of 1997, moreover, the Budget Act has altered the budget process. A nominal spending ceiling has been introduced and applies to a moving three-year period; this means that additional spending in one field has to be financed via reassessments elsewhere so that the overall ceiling is not exceeded. Expenditures during the current fiscal year are also monitored more closely; if items are expected to exceed the budgeted figure, the competent ministry has to propose ways of preventing this.

Institutional changes are also on the way in the domain of monetary policy. The status of the Riksbank is to be strengthened as of 1999. As a result of the five-party agreement, the inflation target is to have the force of law. The ban on giving instructions is to be statutory. The only grounds for dismissing the Riksbank governor are to be serious misconduct or an inability to continue to fulfil the conditions required for the performance of his/her duties. Concerning monetary and exchange rate policy decisions of major importance, instead of the present obligation to consult the Minister of Finance, in future the Riksbank will simply inform him/her. The agreement also provides for a different managerial structure, an adaptation in accordance with the Maastricht Treaty, and changes in the right to decide exchange rate policy. In exchange rate policy matters the Riksbank has a stronger legal status than the ECB. All this makes the Riksbank one of Europe’s most legally independent central banks.

A European context

The fact that Sweden will not be adopting the single currency from the start does not mean that Swedish economic policy can be constructed independently of opinions in other EU countries. Cooperation and dialogue with other member states are requirements that have grown up with the increasingly pronounced economic integration and definitely applied when we joined the Community. The Maastricht Treaty stipulates that we are to regard our economic policy as a matter of common concern. We shall therefore continue to participate in the discussions in Brussels at which the economic policies of member states are deliberated and assessed.

We will take part once a year in the construction of the broad guidelines for economic policy. The Stability and Growth Pact applies to Sweden even as a non-euro member state. We are admittedly not liable to sanctions but we are under an obligation to fulfil the Pact's objectives. We have also undertaken to explain our policy continuously in convergence programmes that require the approval of the other member states. Moreover, the Treaty requires us to regard our exchange rate policy as a matter of common concern.

These arrangements mean that we continuously participate in the joint supervision of economic policies in the Community and have to explain and defend the policy we pursue. Conducting a policy that differs in essentials from the Community's declared objectives is scarcely feasible and, at least as far as Sweden is concerned, undesirable. The pressures from joint processes of this kind should not be underestimated.

5. Conclusion

The countdown to the economic and monetary union is proceeding rapidly. All the preparations throughout Europe will have to be completed in the course of this year so that the single currency can be adopted from the beginning of 1999. Most of the major and difficult decisions have already been made. In about three months time the EU countries will have selected the member states that are to constitute the euro area. The new European Central Bank will then be launched and dress rehearsals can begin. EMU is indeed on the way.

Much will be required of both the ECB and the governments of participating countries in the form of a credible policy. The legal framework provides good conditions for this. But of course there are elements of uncertainty. One important issue is the formulation of economic policy cooperation in the union. Only time will tell just how this matter will be settled.

EMU will entail changes for the players in financial markets as well as for other economic agents, like households and firms. Sweden is no exception, though the drama should not be exaggerated. The tendencies are gradual and much has already happened.

The conditions for economic policy in Sweden will also be affected. In the wake of excesses in the 1980s, the realignment of Sweden's economic policy in the early 1990s led initially to considerable convulsions. Today, however, our stabilisation policy stands up well in a European perspective. Government finances have been improved in record time and inflation is low. New rules have been established for both fiscal and monetary policy. The task now is a consistent continuation of this policy.