

Mr Heikensten discusses the new currency and the Swedish economy

Speech by the First Deputy Governor of the Bank of Sweden, Mr Lars Heikensten, before the Swedish Shareholders' Association in Sölvesborg, Bromölla, on 23/1/99.

On New Year's Day, ten currencies in Europe were replaced by a single, common currency. The changeover went well, no doubt exceeding some expectations. The elaborate systems that were used in earnest for the first time to transmit cross-border payments functioned properly, with no serious technical hitches. This made it possible to establish a uniform instrumental rate for monetary policy throughout the euro area. The new currency also had a favourable reception in financial markets, accompanied by falling interest rates.

EMU has thus got off to a successful start. But the challenges posed by monetary union and any risks connected with the project are mainly of a different nature. They are economic and political, affecting the participants as well as non-euro countries. With eleven countries subscribing to a single monetary policy, the conditions for economic policy in Europe have changed. So have the terms for Sweden and economic policy here. These matters have not yet been discussed at all fully in Sweden.

Under these circumstances, I shall be opening our debate today by touching briefly on four issues: the new challenges posed by the euro to economic policy in Europe; the consequences for Sweden; the path of the krona's exchange rate; and current monetary policy.

Challenges to EU economic policies

The euro's successful launch was underpinned by intensive preparations. Now that the euro has been introduced, there is still work to be done to ensure that the monetary union also functions properly in the longer run.

One of the major challenges is to achieve a good working relationship in the euro area between the single monetary policy and other components of economic policy. Achieving this interaction can be difficult even at the national level. Sweden's problems in the 1980s are a good example: fiscal policy was not sufficiently tight to counter the rapid expansion of credit and neither was the supply side functioning all that well, which also contributed to the overheating. In the monetary union, the single monetary policy has to mesh with the national fiscal, wage and structural policies of eleven countries.

While decisions about the other components of economic policy are still mainly national, they are highly important for the monetary union's success. It is envisaged that good interaction will be achieved in that the euro countries monitor each other and jointly discuss their national policies. Starting from mutually agreed policy guidelines, each EU country is to present regular accounts of how it intends to fulfil the common objectives. If a country's policy diverges from the agreed guidelines, the idea is that other countries will protest at an early stage; each country must shoulder its share of the responsibility for this.

The work of constructing uniform rules has made most progress in the field of fiscal policy. Here the Stability and Growth Pact lays down clear constraints on budget policy: the countries are to strive for budgetary positions close to balance or in surplus in the medium term and under normal circumstances they are to prevent the budget deficit from exceeding 3 per cent of GDP. A process has been set up for supporting the forces in each country that back a responsible policy. The process gets its muscle from the ultimate possibility of applying sanctions to countries that do not follow the guidelines.

The background to the EU countries' agreement on strict guidelines in this field is the concern about the size of government debt and the central role of fiscal policy in relation to monetary policy. Fiscal policy affects price stability both via the level of economic activity and via expectations of future inflation. Without the support of generally consolidated fiscal policies in the euro area, the task of achieving price stability would be a heavy one. Problems and shortcomings in fiscal policy hit growth and employment in that they necessitate a level of interest rates that is higher than otherwise.

Today, far too few countries fulfil the medium-term fiscal policy objectives and the major euro countries have very small margins to the Pact's definition of an excessive deficit. This can lead to problems in the Union, particularly if a weaker economic development were to result in further budgetary deterioration.

Considering the size of government debt in a number of EU countries, continued adherence to a tight budget policy is to be desired. Such a policy can make further interest rate cuts possible if economic activity slackens and inflation prospects improve. There is a consensus on this today in the European Union but reaching an agreement on how the countries should share the burden of adjustment can be difficult. It will no doubt require many lengthy discussions, which have already begun, between the finance ministers of the euro countries.

Consequences for Sweden

The Riksdag (Sweden's parliament) has decided to stay outside the monetary union at present. We are accordingly continuing to conduct our own monetary policy with a flexible exchange rate and an inflation target.

The *political consequences* of being outside the euro area were considered by the Riksbank in its submission on the report from the EMU Enquiry. The conclusion that the consequences would be considerable has been reinforced now that the monetary union has started with eleven countries. This would be even clearer if Denmark and the United Kingdom were to decide to join.

It is also clear, from discussions in which I have taken part, that the advent of the euro has been accompanied by closer collaboration on the construction of economic policies in Europe, as well as on Europe's actions on the global stage. In these respects Sweden now carries less weight.

A distinct message that we intend to remain outside the euro area for the foreseeable future would probably weaken our influence in the European Union still more. Our partners in Europe would then be less interested in allowing for our positions on other matters as well. The monetary union is, after all, one of the Community's most central integration projects.

On the other hand, the *economic consequences* of Sweden still having a flexible exchange rate should not be exaggerated, at least in the short run. Basically, the development of the exchange rate and interest rates depends on how we manage Sweden's economy relative to the euro area. If we succeed in making our economic policy credible, the costs of remaining outside for some years should not be unduly high. But our decision not to participate does mean that we need to be extra clear in demonstrating our determination to implement a sound economic policy, focused on sustained growth with low inflation and high employment. There are no easy short cuts, even in the short run.

That Sweden, as a euro outsider with a flexible exchange rate, will have to live with exchange rate fluctuations is evident from events last autumn. We know from international experience that

floating exchange rates do in fact float. Not even good economic fundamentals suffice to ensure stability in financial markets. Here we have a price for being outside the monetary union.

The exchange rate

The exchange rate is an important but elusive item in assessments of inflation. Last autumn, the main assessment was that the krona would become successively stronger as the financial turbulence subsided and relatively more importance was attached to the favourable economic fundamentals, which include low inflation and a growing surplus on public finances. Recently, moreover, it seems that such a process has begun. Signals of a move by Sweden towards the monetary union may perhaps have acted as a catalyst here.

The new political signals about the handling of the EMU issue have brought the question of the krona's equilibrium level to the fore. Participation in the euro area means that at some stage the krona's exchange rate with the euro will have to be locked. In the discussion that will then be held with colleagues in Europe, the actual decision will be a matter for the Government. The Riksbank, however, is responsible for choosing the conversion rate we find reasonable on Sweden's behalf. Meanwhile, we must bear in mind that we are dealing with negotiations between Sweden and the other EU member states, so it may be inadvisable to get tied down in matters of detail at an early stage.

The Riksbank has made it clear on numerous occasions that it considers the krona to be undervalued. Much of the debate on this issue has stemmed from an article on the krona's equilibrium exchange rate that was published early in 1996 in our *Quarterly Review*. The article was intended to serve as a basis for public debate; in our opinion it provided the best foundation that was then available for discussing the krona's long-term value.

The krona's equilibrium value is naturally something that the Riksbank considers continuously and the analysis is constantly being developed. Accounts of various aspects of the exchange rate have been presented in the *Inflation Report*. The material that will be produced in the event of Sweden deciding to participate in ERM2/EMU will have to incorporate the additional information since 1996. It should also be noted that the levels and intervals that were presented in the article refer to the krona's trade-weighted exchange rate and are therefore not directly applicable to the question of a reasonable central rate for the krona against the euro. Furthermore, the euro is a new currency. Arriving at just the right future exchange rate for the krona against the euro is therefore not exactly easy.

Although the financial markets are naturally eager to know, at this stage it is too early to allow the discussion of the krona's path to focus on specific intervals or levels. But the course is clear—in the event of a euro peg, the rate for the krona will be stronger than the current level.

Current monetary policy

In conclusion I should like to say something about the monetary policy situation in Sweden. International economic prospects gradually deteriorated during 1998. Knock-on effects from the crisis that originated in Asia were included from an early stage in the Riksbank's spectrum of risks. Early in 1998, it was judged that they would be countered by other factors, not least a good development of domestic demand. In June, however, when price tendencies proved to be more subdued than expected earlier, the repo rate was lowered by 0.25 percentage points.

During the autumn, increasingly clear signs of an international slowdown were accentuated by growing turbulence in financial markets. The Riksbank considered that the effects on the

Swedish economy and the path of inflation would be of a magnitude that warranted an easing of the monetary stance. In November the repo rate was accordingly lowered in two steps from 4.10 to 3.60 per cent. In the December *Inflation Report* the assessment was still that in one to two years time, both CPI and underlying inflation would be below the Riksbank's price stability target of 2 per cent. On December 16th the repo rate was therefore lowered by another 0.20 percentage points to 3.40 per cent. With this cut, the monetary stance was considered to be well balanced; responsibility for monetary policy's future formulation was left to the Riksbank's new Executive Board, which would be taking over in the new year.

Since the publication of the December *Report*, international economic activity can hardly be said to have changed appreciably for the better. Prospects for both the euro area and the Japanese economy seem to have worsened, if anything, at least for the coming year. In the euro area it is manufacturing which has weakened in particular, while consumption still seems to be following a relatively favourable path. Developments in the United States are still fairly strong but some slowdown is still foreseen. The situation in Brazil in recent days has created some renewed unrest in international financial markets, with a limited flight to safe assets. This, too, may affect future international activity, though the turbulence in the wake of the falling real seems, if anything, to have been less than expected.

The economic statistics for Sweden suggest that industrial activity may go on weakening. The picture of total resource utilisation is still difficult to assess but there is much to suggest that the proportion of unutilised resources is still comparatively large. Forward indicators, such as incoming orders, also point to a further deterioration.

At the same time, households' expectations of their own economic situation indicate that the development of private consumption will remain relatively good. Household optimism is supported by increased employment and a favourable development of disposable income. However, the sustainability of this development is uncertain, as it was last autumn, partly because households and firms differ in their assessments of the future. Negative news from the business community may make households more pessimistic, and so may renewed unrest in financial markets. Recently, moreover, there have been tendencies for households to be more uneasy about their own economic situation.

A more positive development is favoured by the fact that the international financial crisis has subsided. During the autumn there were strong fears that financial problems would subdue international activity for several years. With the normalisation to date, the probability of this has decreased.

The December outcome for consumer prices was somewhat lower than expected. The CPI fell 0.6 per cent, which can be compared with our forecast of a fall of 0.3 per cent. The main explanations are a weaker development of commodity prices and falling interest rates.

The assessment of future inflationary pressure has to take these and other factors into account. At the same time, the downward path of market interest rates in recent months represents a demand stimulus further ahead. This, too, must be considered in the assessment of inflation.

If nothing untoward happens, the Riksbank's next monetary policy meeting will be held on February 11th. It will then be up to the new Executive Board to evaluate the information that has been received and decide the level of the repo rate.

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