

Mr Heikensten discusses whether Sweden should join the euro area

Speech given by Mr Lars Heikensten, Deputy Governor of the Sveriges Riksbank to Stockholm City's financial staff on 3 September 1999.

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Besides being one of the most momentous changes in the continent's economic policy for many decades, the introduction of the single European currency at the beginning of this year was a major step in the political process that has been bringing the countries of Europe closer together since the 1950s. When EMU is debated in Sweden, the latter aspect tends to be neglected in favour of more or less short-run economic advantages and drawbacks.

In 1997 the Government and the Riksdag (Sweden's parliament) decided that Sweden would not be adopting the single currency from January 1999. A lack of popular support was given as the reason. Euro area participation at a later date was not ruled out, however, and it was underscored that Sweden must therefore have its options as open as possible. For true freedom of action there are certain definite requirements. Policy must remain focused on stability so that we can fulfil the jointly agreed criteria for entry. Sweden must follow developments in Europe and make practical preparations so that participation is feasible when we want to join.

Freedom of action also requires that we are knowledgeable about the monetary union and actively debate its issues. Today I intend to make a contribution to that discussion.

What I have to say starts from the report that Lars Calmfors and his colleagues presented in 1996 – one of the most extensive and penetrating studies of EMU membership's pros and cons. When the report was circulated for comments, the Riksbank had the opportunity of submitting an opinion and stated that Sweden ought to participate in the monetary union right from the start.

I shall be reminding you why the Riksbank came to this conclusion and commenting on how subsequent developments have influenced my own view of the matter. The foundation for my personal opinion includes my working experience as a close monitor of economic developments and debates, both in Sweden and internationally. This has involved participation in the European discussion over the past three or four years as Sweden's representative in the EU's Economic and Financial Committee (formerly the Monetary Committee).

Arguments for and against

Calmfors and his colleagues considered that Sweden ought to join the monetary union but that there were good reasons for waiting. The arguments for and against were presented in the report under three headings: stabilisation policy, economic efficiency and political reasons. In view of this classification's educational merits, I shall be using it here.

The report's arguments from stabilisation policy

The arguments from stabilisation policy focus on ways in which EMU membership could be expected to affect the possibility of achieving a balanced economic development in Sweden, with good economic growth, high employment, price stability and external balance. The report considered that the arguments in this respect were not clear-cut either way but that the advantages of staying outside for the time being predominated. With a national monetary policy at a time when the economy still had major imbalances and was highly vulnerable to shocks, Sweden would then be in a position to parry any negative repercussions that might hit the economy while leaving the euro area relatively unaffected.

A radical change in conditions for the forest industries is the standard example of such a shock. But even a more general worsening of conditions for growth in the rest of the world might have particularly adverse effects for a small economy with a high level of foreign trade. Moreover, with an independent monetary policy, interest rates can be increased to counter effects of a specific domestic policy failure, for instance an excessively weak budget policy or inflationary wage settlements. At present some observers might perhaps regard this as the greatest risk.

According to the report, the high unemployment that had occurred in Sweden since the early 1990s made constraints on Swedish monetary policy particularly risky. In the situation at that time, a shock could have serious consequences for unemployment, with a further increase from a level that was already high. Experience in other countries, moreover, pointed to a major risk of an increase in unemployment becoming permanent. Swedish monetary policy could then provide support for the necessary labour market reforms that were advocated in the report. Swedish participation should wait until these reforms had been implemented and unemployment had fallen. For similar reasons, the weak public finances might also heighten the risks associated with Swedish membership.

In the ensuing debate, the stabilisation policy argument against EMU participation came to be called the insurance argument. By retaining a national monetary policy, Sweden could insure itself against the potentially major negative effects of a macroeconomic shock.

At the same time, the report pointed out that participation in the monetary union could confer benefits from a more stable exchange rate. But the authors did not believe that such benefits would outweigh the advantages of retaining a national monetary policy.

The Riksbank's opinion

The Riksbank did not agree with the report in every respect. The Governing Board considered, for instance, that it exaggerated the risks of an external shock hitting the Swedish economy alone. The Board noted that to a large extent the shocks in Sweden since the 1970s could be said to have been self-inflicted. The divergent cyclical pattern probably had to do with the direction of economic policy, where strong fiscal stimuli and repeated devaluations had generated high inflation and problems with costs.

The Board also stated that the report exaggerated policy's freedom of action in reality in an outsider position: it would not be possible for Sweden to implement a monetary policy that differed markedly from that in the monetary union. This was evident from Sweden's history of uncertainty about government finances and high inflation were Sweden to choose the outsider alternative on the grounds of the insurance argument, this could be perceived as a signal that Sweden's economic policy would again become accommodating. This risk was also mentioned in the report.

The Riksbank fully agreed, on the other hand, that unemployment is a serious problem in the Swedish economy. But we did not consider that this problem could be resolved by remaining outside the monetary union. As the report had indeed pointed out, other measures were needed to improve the workings of the labour market and wage formation. The Riksbank underscored that the necessary structural measures for the labour market would be easier to implement if we had established the credibility of an economic policy for sustainable growth.

Does the stronger economy warrant different conclusions?

In the light of all that has happened in the past two or three years, the assessments presented in the report and by the Riksbank should perhaps be modulated.

The case for an insurance policy and freedom of action was argued at a time when public finances were weak and unemployment was still at a record level. The measures of economic policy had admittedly begun to build up public confidence in a more stable future after the profound crisis in the early 1990s but the outlook was still uncertain.

Today the situation is better, with a central government budget surplus and high ambitions for fiscal policy. In both these respects Sweden does well in a comparison with euro countries. Also, for several

years now inflation has been at least as low as in the euro area. It is no less important that a number of urgent institutional changes have been made, with major consequences for the implementation of stabilisation policy. The budget process has been tightened and a new legal framework has been set up for a more independent Riksbank. Recently, moreover, unemployment has decreased appreciably, though the extent and duration of the reduction are still uncertain. This will ultimately depend on future wage settlements.

So all in all, the economic situation in Sweden is more stable than I had at least dared to hope for a couple of years ago. This in turn is reflected in, for example, a level of interest rates that is only marginally different from that in the euro area.

From this it might be concluded that Sweden can now stand on its own two feet – we can evidently cope without EMU. However, one reason for being a little cautious about this conclusion is that, to some extent, the lower interest rate probably has to do with many people's expectations that by and by Sweden will in fact join the monetary union. Personally, moreover, I have never considered that Sweden ought to adopt the single currency primarily in order to tackle problems of stabilisation policy or reap the benefits of a lower interest rate.

The question of whether or not to join the monetary union mainly has to do with long-term aspects of economic development and how we in Sweden view our future political role in Europe. In this perspective, today's stronger Swedish economy is an argument in favour of adopting the euro *now* rather than for remaining outside. Some of the Calmfors report's arguments against participation have been weakened. A decision to join – based on long-term, strategic considerations – is now associated with smaller short-term risks than it would have been some years ago.

The report and the Riksbank on economic efficiency

The next step of the analysis in the Calmfors report concerned the consequences of membership for resource utilisation, that is, how the long-term output trend might be affected by the impact of membership on, for example, investment, foreign trade and transaction costs.

The report focused on the effects that are easiest to measure and assess. The decreased costs for currency exchange and covering foreign-exchange transactions were seen as definitely positive. The report was uncertain both about the magnitude of this effect and about the effects on foreign trade and investment but came to the overall conclusion that they were not particularly large.

The Riksbank considered that the report underestimated participation's effect on efficiency. One reason for this was the report's assumption that firms could reduce the costs associated with exchange rate movements by covering them in financial markets. The Riksbank believed this expenditure would be higher than estimated in the report and that small and medium-sized firms in particular would find it difficult.

The Riksbank also drew attention to the risks of Sweden being discriminated against in various respects. One example was the disadvantageous terms for outsider countries in TARGET, the European payment system. Moreover, an outsider position *for the time being* would involve additional costs in various parts of the economy. Financial institutions, for instance, would have to operate twin systems in order to remain competitive.

Negative long-term effects of remaining outside

Such is the nature of the long-term effects that assessments of them are unlikely to change fundamentally in the course of a year or two. Still, there is new and additional information that may cast a somewhat different light on certain aspects.

One major issue concerns the *link between EMU and the single market*. There is empirical evidence that the single market is exerting downward price pressure in the European Union. Some assessments suggest, moreover, that EMU may lead to a further price fall; figures as high as 10 to 15% have been mentioned. If the effects were to be of that magnitude, the welfare gains would be substantial.

In practice, however, it is not easy to distinguish the parts that EMU and the single market are playing in price formation. Empirical data therefore have to be treated with caution. At the same time, EMU and the single market are linked at another level; as an American colleague recently remarked, "If EMU would help to secure the single market's survival, it's worth all the other risks."

Another important long-term consideration is the *structure of Europe's business sector*. I believe we are now experiencing a formative phase. European manufacturing and services companies are being rapidly restructured, with effects that are likely to be considerable. Many forces are contributing to this process; the globalisation of production is one and another is the single market. But there can be hardly any doubt that EMU is also playing a part, particularly for the financial sector. Participation in the euro area would give Sweden and Swedish companies access to a larger capital market that is expanding rapidly. Assessing what being outside the monetary union entails in this phase is not easy. Personally I believe the effects are negative. I also think they may turn out to be considerable.

A related matter is the *location of companies*. Representatives of large Swedish groups, as well as the Federation of Swedish Industries, for example, frequently state that euro participation would result in higher investment in Sweden by both Swedish and foreign companies. This argument has also been heard recently in connection with some of the relocations of large companies. Decreased exchange risks would be one of the reasons. Another, it is sometimes suggested, would be that the economic framework for firms would be perceived as more secure and stable if Sweden adopted the single currency. Once again, the strength of these arguments is difficult to assess, partly because they have evident political purposes. But opinions of this type may clearly have effects if they are current among central decision-makers in the business sector.

Political arguments favour participation

This brings me, finally, to the political arguments for and against adopting the single currency. The Calmfors report discussed the implications of participation for Swedish policy and its legitimacy, as well as the consequences for Sweden's voice in Europe and the world. On the first point I shall simply say that I agree about the importance of any decision to participate having a high degree of legitimacy. This in turn calls for an animated discussion of the EMU issue.

Having said that, I shall now concentrate on the other aspect. The report considered that if Sweden participated in the monetary union, we would be in a better position to influence EU decisions. The more countries that participated, the greater would be the strength of this argument.

The Riksbank agreed but found the argument unduly cautious as regards the political advantages. We saw major political benefits from participation and considered that an outsider position would clearly weaken Sweden's voice in the European debate and decision-making process.

As I see it, since the report was presented and the Riksbank submitted its opinion, the political argument has gained appreciable weight. The initial participants number 11, instead of the 6 to 9 countries that seemed most probable to Calmfors. That by itself means a great deal. It is a matter of simple logic: if you belong to a club in which 6 out of the 15 members make a move, there is no cause to feel an outsider; matters are different when 11 members decide on a course of action and support it whole-heartedly, leaving only 4 on the sidelines.

It is perfectly clear that EMU is a major project – perhaps the most important at present – in the process of European integration. A great deal is being invested in it and the EMU process also affects policies in other areas. But let us not exaggerate: experience differs from area to area and Sweden's voice is naturally not shorn of all its weight just because we are outside the euro area.

As regards economic policy – the only area of which I have direct experience – the pattern is clear. It surprised me how quickly the euro countries saw themselves as a single unit and the ways in which this altered the agenda for our committee meetings. In that the finance ministers of the euro countries have formed a separate group, Euro 11, to some extent Sweden is excluded from the interesting discussions.

The Community agenda is being constructed in the light of needs among the eleven members of the euro area. The matters of economic policy that are up for EU discussions are also more specific than before. How is economic policy to be formulated? How can the labour market be made to function better?

At the European Central Bank we have missed the train on which the participating central banks designed their monetary policy strategy and decided how the functions of the system of central banks are to be performed. If we join the monetary union in the future, influencing the procedures of the ECB and the formation of monetary policy will be more difficult.

In the economic domain the European Union is also increasingly tending to establish joint European positions, for example on such matters as the crises in Russia and Brazil, the role of the IMF, etc. Here, too, I consider we are in a formative phase. Guidelines are now being drawn up for how Europe is to be represented on international bodies and in the work of developing a new international financial structure. The questions include the future status of the G7, G10, G33 and other informal groups. In these contexts we are now becoming rather isolated.

Conclusion

Now for a brief summary and some conclusions.

EMU is a part of the effort that has been in progress for more than five decades to bring the countries of Europe closer together. Today the monetary union is perhaps the most important EU project and as a member of the Community we cannot disregard it. If Sweden chooses to remain outside, it will ultimately be difficult to get the participating countries to understand our actions.

The fact that the monetary union is a major component of a larger process of integration means that we cannot expect to get simple answers to our questions by adopting an attitude of wait-and-see. Assessing the project over a complete business cycle certainly has its advantages but the prevailing uncertainty is costly. Investments are postponed or shelved. Twin systems have to be maintained. I am convinced, moreover, that new questions will arise all the time. We shall never be able to tell just how EMU will develop. This is something that those who participate decide as they go along.

In the event of turbulence in the world around us, participants in the euro area have extra protection. This was evident last autumn, when the financial market turbulence hit the Swedish krona more heavily than the Finnish markka. On the other hand, as euro participants we would be in the same boat as at least eleven other countries. That naturally implies greater dependence – we would be clearly involved in problems that arise in the euro area. The only way to counter that would be by actively influencing developments in the euro area in the right direction.

An insurance argument can be put for remaining outside the euro area. If we continue to manage the economy properly, there should be freedom of action in our economic policy. But this is not a simple matter. On the contrary, we must convince the rest of the world that we have not refrained from adopting the euro so as to be able to devalue the krona if the going gets tough.

The long-term positive effects of joining the monetary union should not be played down just because they are difficult to measure. The participating countries and markets are drawing closer to each other. This probably affects competition, investment flows and prices to a greater extent than traditional models are able to show. I believe that the costs of staying outside are particularly great at present and in the coming years, for instance as EMU generates far-reaching structural changes in the business sector.

To this should be added the political arguments. Sweden has already lost influence in the area I am best able to assess, economic policy. This is particularly serious today as the global financial map is being redrawn and we need to assert our position as a small country in Europe. Others are better placed to pronounce on other areas but it seems logical that our positions there are also being weakened because we are not seen as a fully-fledged participant in EU cooperation.

Finally it is a matter of weighing all these arguments against each other. The assessments involved, economic as well as political, are naturally difficult. But in the interval since the Riksbank submitted an opinion on the Calmfors report, I have not changed my opinion: Sweden ought to join the euro area as soon as possible.