Mr Heikensten discusses monetary policy aspects of Sweden's position "inside EU, outside EMU"

Speech given by Mr Lars Heikensten, First Deputy Governor of the Sveriges Riksbank, at a seminar arranged by Handelsbanken Markets, Stockholm, on 10 September 1999.

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First a word of thanks to those who arranged this seminar for inviting me to take part. The agenda covers many important issues that all deserve a thorough discussion. Sweden's relationship with the European monetary union is one of them.

Today I shall be considering four matters: the feasible timetable in the event of full participation in EMU; Sweden's performance as regards the criteria for joining the euro area; considerations concerning the rate for the krona's conversion to euro; and, finally, something about how economic policy should be formulated in the meanwhile in the event that we do join the monetary union.

When could we join?

The timetable in the event of our participation in the monetary union is set both by decisions in Sweden and by negotiations with the existing euro countries.

As regards the domestic process, in December 1997 the Riksdag (Sweden's parliament) decided that Sweden would wait and see, but that the door to future participation is not to be closed. Players in the financial markets, along with other observers, are now trying to work out whether this door will be opened wide and, if so, when that is likely to happen.

Our Prime Minister has stated that the question will be discussed at the Social Democrats' party congress next March. If the congress were to agree that Sweden ought to join, the next step, to quote the government bill, is for the matter to be "submitted to the people of Sweden for assessment". This can be done in a referendum or an election. An affirmative response would be followed by a government bill, leading to a parliamentary decision on an application.

In the speculation about the timing of a participation, what is known as the fast track has been seen by observers as a feasible scenario. It assumes that all the competent bodies are in favour of participation and that the matter is referred to a referendum, in which case the domestic side of the decision-making process could be completed some time around the turn of 2001.

However, such a short run-up to euro participation cannot be taken for granted. The Social Democrat congress may refrain from considering the matter or arrive at a more tentative conclusion, for instance along the lines of the British government's declaration in favour of participation, but not for the time being. That would alter and prolong the process. A number of forecasters and political observers have in fact revised their assessments recently in favour of a later date for Sweden's probable participation.

If and when Sweden does opt for participation, the matter will be negotiated with the other EU countries. This will be done on the basis of examinations of the Swedish economy by the EU Commission and the European Central Bank (ECB). Those assessments will be discussed by the finance ministers of the member states, who will then hear the opinions of the EU Parliament and the heads of state or of government before arriving at their decision.

When that decision has been made, the member states must also agree on the time that Sweden should have for completing the necessary preparations. The countries that participated from the start have been given a transitional period of over three years from the euro's introduction in January 1999 until it completely replaces the national currencies not later than June 2002. That a similar arrangement would apply for Sweden is, however, not certain. If we consider that our preparations can be completed more quickly, perhaps we could ask for a shorter interval.

Do we meet the entry criteria?

The Commission and the ECB will be examining the Swedish economy with reference to the criteria that were included in the Maastricht Treaty. Those criteria are for inflation, long-term interest rates, the exchange rate, the government budget balance and government debt. There are also specific requirements as regards central bank legislation. The principle of equal treatment will apply; that is, the basis for the assessments is to be the same as for the initial group of euro participants. That means that some conclusions can probably be drawn from the examinations in May 1998.

Compared with the countries that passed the entrance examination at that time, Sweden's economy is doing well. We have managed to achieve stable government finances and combine this with persistently low inflation, with the result that long-term interest rates have fallen towards the European level.

In the present situation, Sweden would have little difficulty with the criteria for inflation, the long-term interest rate and government finances. The budget surplus of around 2% of GDP is clearly better than the criterion of a deficit of not more than 3%. Government debt is still above the convergence criterion of 60% but should not constitute an obstacle; the debt is being rapidly reduced – according to the Spring Bill by almost 10 percentage points from 1988 to 1999 – and countries with a weaker position in this respect were admitted in the initial round. Moreover, economic forecasts for Sweden point to the continuation of strong government finances, making more debt repayment feasible and thereby a further improvement in this position.

The criteria for low inflation and interest rates are formulated in relative terms. Comparisons with the level of inflation and interest rates in the three euro countries where inflation is lowest show that Sweden would fulfil these criteria today and current forecasts suggest that the same holds for the coming years.

The criterion for exchange rate stability is more complicated. The Treaty states that for two years before the examination the national currency is to have been inside the normal fluctuation margins provided for by the Exchange Rate Mechanism (ERM). The process by which the initial group of participants was selected suggests that the criterion could be interpreted somewhat more freely. Finland and Italy were both approved in May 1998 even though their currencies had then been participating in the ERM for only around eighteen months.

The other countries may also have reasons for not insisting too strongly on a strict interpretation of formal participation by outsider countries. Considering the apparent strength of British opposition to a fixed exchange rate arrangement, such an attitude might obstruct a British membership of the euro area. It seems to me that in this respect the United Kingdom is in a more difficult position than Sweden. Our Government and the Riksdag have stated that participation in ERM II can be seen as a direct preparation for joining the monetary union; the Riksbank has noted that we do not see any problems with that. In a future situation where a referendum or a general election has resulted in a positive attitude to the monetary union, it is difficult to envisage Sweden's participation in ERM II as posing any major political problems.

Regardless of the formal requirements that may apply at the time of the examination, the assessments in May 1998 indicate that a central factor in the evaluation will be how the exchange rate has actually developed. Exchange rate stability will probably be analysed with respect to the period before as well as during participation in ERM II. The relationship between the krona and the euro[1] has been relatively stable since the beginning of 1996. Disregarding the exceptionally turbulent period last autumn, during this period the fluctuations around a krona/euro rate of 8.70 have been largely inside a margin of ±2.25%.

[1] The synthetic euro up to the turn of 1998.

How is a reasonable exchange rate decided?

When, or if, the time approaches for a Swedish decision to join the monetary union, it will thus be necessary to consider the question of participating in ERM II. Since the beginning of this year, the matter of whether and when the krona is to be included in the Exchange Rate Mechanism is something that the government decides, albeit in consultation with the Riksbank. At the same time, the krona's central rate with the euro in ERM II and the margin for fluctuations are matters for which the Riksbank is accountable. So in practice, the new allocation of responsibilities means that the government and the Riksbank have to reach a consensus on the terms for the krona's participation in ERM II.

But these terms are not decided by Sweden alone. The central rate and the band width will be negotiated between Sweden, the countries in the monetary union and the non-euro countries that are members of ERM II. The negotiators include finance ministries as well as central banks.

It is clearly important that Sweden and the other countries try to agree on an exchange rate that is as reasonable as possible. This is because the central rate that is set for participation in ERM II will very probably be the rate for the krona's subsequent conversion to euro on joining the monetary union. Consequently it ought to be an exchange rate that is commensurable with real economic equilibrium; in other words, the rate the krona would have when Sweden's economic resources are being fully utilised without this generating inflationary pressure and external debt is sustainable in the long run.

At the same time, the problem of arriving at a reasonable rate should not be exaggerated. Any nominal exchange rate whatever could, in principle, be said to be commensurate with real economic balance. Via adjustments in wage and price levels relative to the rest of the world, the economy will sooner or latter attain its real equilibrium exchange rate. But the question, of course, is how extensive and costly the economic adjustments would be. Evidently, the goal must be to keep such costs to a minimum.

All the negotiating parties have a strong practical interest in setting the rate correctly. An unduly weak krona would admittedly favour Swedish exports, but it would be disadvantageous for the competitive position of the other countries and could also lead in time to higher inflationary pressure in Sweden. An unduly strong krona, on the other hand, would benefit the other countries' competitive position, but also dampen economic activity in Sweden to the detriment of demand for the other countries' exports.

Assessments of the appropriate exchange rate cannot be based solely on a particular model. Besides comparing various prices and costs, allowance must also be made for other indicators of the state of the economy and their future paths. In earlier negotiations, the rate-setting decisions have rested on the macroeconomic situation in the country in question and the rest of the world, various indexes of competitiveness and, not least, the exchange rate's average level and its fluctuations in recent years. The agreed rate has often been the prevailing market rate or a rate close to this.

How should economic policy be formulated?

The room for discretion in monetary policy will be affected if Sweden participates in ERM II. One extreme in that situation would be for policy to focus on a strict exchange rate target, so that the interest rate is set exclusively in relation to the exchange rate tendency. In practice, the Riksbank would then fully follow the ECB's footsteps. The other extreme, you might say, would be for monetary policy to continue to target inflation, still with the exchange rate as one of the set of indicators of inflationary pressure in the Swedish economy. The construction of ERM II, with a broad band for exchange rate fluctuations, would then make it possible for the interest rate to deviate somewhat from the level in the euro area.

The problems that may arise in such a situation depend on how economic policy in general works. Provided Sweden is more or less in phase with the cyclical pattern in the euro area, there need not be any serious conflicts. The monetary policy objectives are broadly the same.

There are therefore grounds for supposing that monetary policy can be much the same as at present. The starting point here is a credible central rate that market players expect will be the rate at which the krona is ultimately converted into euro – two assumptions that are both very reasonable. A case in point is what happened in Finland. Monetary policy there continued to target inflation even after the markka had been included in ERM II; following its entry, the markka stabilised and was close to its central rate.

This brings me to the recent discussion in Swedish media. Briefly, it has been argued that Sweden is in the process of moving out of phase with activity in the euro area, mainly because fiscal policy is unduly expansionary. At present we can handle such a situation because Sweden is in a position to implement an independent monetary policy focused on price stability; the Riksbank can quite simply raise interest rates and thereby counter any tendencies to overheating. Participation in the monetary union, however, would deprive us of that possibility and we would then run the risk of landing once more in a situation like that in the late 1980s.

This account of the problem has a kernel, to which I shall be returning shortly, that deserves to be taken seriously. But the arguments also suffer from distinct weaknesses.

For one thing, they assume that policy will be unsuccessful. The starting point is that the fiscal stance will be unduly expansionary and that Sweden will deviate seriously from the cyclical path in the rest of Europe. So far, however, the empirical foundation for this case is weak. What we know to date about fiscal policy indicates that its direction is now becoming more neutral after a series of years in which its impact on the economy has been restrictive. Thus, as things stand at present, Swedish fiscal policy will come to be more in line with the stance in the euro countries. It should also be noted that many countries in the monetary union are doing relatively well there despite a level of activity that for some time has been or is stronger than in Sweden. It is mainly two countries, Italy and Germany, albeit important for the euro area, that have fallen behind appreciably and even there it now looks as though activity has turned upwards.

For another thing, the argument presupposes that any problems with overheating can be tackled successfully by the Riksbank. That is certainly true in the sense that we are able to raise the interest rate and ensure that inflation comes into line with our target. But the picture as presented is too rosy. If wage formation were to fail or budget policy became excessively expansionary, the restoration of a balanced economy would be costly: growth would be depressed and employment would presumably fall when interest rates are raised, accompanied perhaps by an appreciation of the krona. In this sense, access to a national monetary policy is not a patent remedy.

At the same time, it is clear that we – as a member of the monetary union – would lose the option of guaranteeing low inflation even by having recourse to this costly cure. For example, if the labour market organisations were to make unduly high wage settlements or if fiscal policy were to get out of hand, the Riksbank would no longer be in a position to secure low inflation.

To me, however, it is by no means clear that the natural conclusion today is to begin arguing that Sweden ought not to aim for euro area participation as soon as there is political support. Compared with a couple of years ago, the economic situation is now more stable in almost every respect. It is not only that the economy has adjusted in various ways to lower inflation; government finances have also improved and during the past year employment has risen rapidly. To this should be added the support from institutional changes in budget work and the legal status of the Riksbank.

The natural conclusion is completely different. In the years ahead it will be a matter of cultivating our achievements. This means not losing the grip on fiscal policy, even though in simple book-keeping terms there may be some room for expansion. The target of a 2% surplus over the business cycle will not be credible; neither will it provide any room to manoeuvre when activity slackens, if the surplus when activity is strong is not considerably larger. Everything must be done, moreover, to make the labour market function properly. Now that activity is rising and new jobs are being created, it is particularly important to make every effort to ensure that the vacancies are filled without delay. It is also crucially important that wage formation functions satisfactorily and that wage costs stay well in line with the growth of productivity.

It is only by conducting policy along these lines that Sweden's options on the EMU issue will remain open as the Riksdag has ordained. Fortunately enough, if we remain outside the monetary union it is also such a policy that we should implement in order to create good conditions for increased prosperity and attain the high goals the Government and the Riksbank have set up for employment.