Nils Gottfries, Why is Sweden not in EMU

Caption: In January 2002, Nils Gottfries, Professor of Economics at Uppsala University and former member of the Swedish Commission on Economic and Monetary Union (EMU), describes the economic and political reasons for Sweden’s decision not to adopt the euro.

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Why is Sweden not in EMU

by Nils Gottfries

Sweden has long had an open economy characterised by extensive trade with the outside world and a liberal trade policy. Exports amount to more than 40 per cent of GNP. The country's capital markets were deregulated in the 1980s, since when movement of capital has been totally free. During the 1950s and 1960s, Sweden had a fixed exchange rate, low inflation, and interest rates largely followed international trends. When the international Bretton-Woods system of fixed exchange rates collapsed in the early 1970s, Sweden sought to maintain a fixed rate for the krona, first against the German mark and then against an index or "basket" of currencies. It was thought that a fixed rate of exchange would have a restraining effect on wage formation. Labour and management in Sweden were to understand that substantial pay increases would lead to reduced profits and a loss of market shares for industries in the competitive sector. In practice, however, the policy misfired. Sweden was caught in an inflation-devaluation cycle in which periods of high demand and high inflation were followed by crises and devaluations. The krona was devalued in 1976, 1977, 1981 and 1982.

At the end of the 1980s, an economic boom developed in Sweden, along with financial speculation, and wages and prices rose faster than elsewhere. Within a few years, the country had sunk into its deepest crisis since the 1930s. Unemployment rose from 2 to 8 per cent, with a further 5 per cent in government relief programmes, etc. The Riksbank (Swedish central bank) strove to maintain a fixed rate against the ecu until 1992 when it gave up and allowed the krona to float in the currency market, whereupon it depreciated sharply.

Up until November 1992, the Riksbank's chief task was to defend the fixed rate of exchange, while decisions on devaluation were taken by the Government. When the krona began to float, new guidelines for Swedish monetary policy were required. The Riksbank declared that its goal would be to keep inflation down to 2 per cent, with a 1 per cent margin either way, and the Government came out in support of such a course. Nowadays, the Riksbank plays a considerably more important and independent role in monetary policy affairs than it used to.

In discussing the Swedish debate on EMU, it is important to remember that Sweden did not become a member of the European Union until January 1995. The margin of victory in the national referendum of 1994 that led to membership was small, and in the years that followed, anti-EU sentiment ran fairly high in Sweden. The Swedes are still unused to the idea of being citizens of Europe.

Unlike Britain and Denmark, Sweden has not been formally granted the right to remain outside EMU, but prior to the negotiations on EU accession the Swedish Government declared that it would adopt a final position on monetary union "in the light of further developments and in accordance with the provisions of the Treaty". Whether or not Sweden joins Europe's single currency is considered an open question in the public debate on the issue.

The EMU report

When reviewing the Swedish debate on EMU, a good place to start is with the Government Commission report on monetary union presented in 1996. The report, which discussed various economic and political aspects of EMU, was prepared by a group of economists and political scientists under the leadership of Lars Calmfors, Professor of International Economics at Stockholm University's Institute for International Economic Studies.

A consensus exists among economists that the best way of analysing the EMU issue is to apply the theory of optimal currency areas, whereby benefits and drawbacks are weighed against each other. The benefits are to be found mainly at the microeconomic level in the form of reduced transaction costs, elimination of the uncertainty caused by fluctuations in exchange rates, simpler price comparisons and enhanced competition in the Internal Market. The main drawback is that national governments waive the right to adapt monetary policy to the current economic situation in their own country. They have no option but to accept the common interest rates and exchange rates that apply throughout the European Union. This becomes a problem in the event of "asymmetric shocks", i e when the situation in one country deviates significantly from the situation in the other countries that are part of EMU. Economists are also agreed that these benefits and drawbacks cannot be analysed in an objective manner. Subjective assessments are required whereby different people are able to arrive at different conclusions.

The Swedish EMU Commission’s report concurred with this analysis. In its summary and conclusions, it judged the economic gains from joining EMU to be "small but certain". On the stabilisation issue, the Commission was of the opinion that a loss of monetary policy independence would not ordinarily create any great problems. But if Sweden’s economy were to fall out of step with the rest of Europe, the common interest and exchange rate would have a destabilising effect. Choosing to remain outside EMU was likened to choosing an insurance policy where the annual price in the form of higher transaction costs, etc, could be viewed as an insurance premium that Sweden has to pay if it wishes to take independent monetary policy action whenever its economy behaves in a radically different way from that of the rest of Europe.

In order to discuss EMU, you need to specify the alternatives you are comparing it with. The alternative scenario that the EMU Commission mainly discussed – and recommended – was a continuation of the floating exchange rate, greater independence for the Riksbank and low inflation as the principal target of monetary policy. The report took the view that such a course, together with a restructuring of government finances, would inspire such credibility that Sweden would eventually acquire interest and inflation rates roughly on a par with those in EMU.

As for the political implications, the report attached considerable weight to the prospect of Sweden’s position in the EU being weakened by a decision to remain outside EMU. By choosing not to participate in the Community’s most important project to date, it said, Sweden would be removing itself from the EU’s inner core, Swedes would be regarded as ‘unwilling Europeans’, and the country would lose influence in other areas.

In its summary and conclusions, the Commission stated that the economic arguments did not currently favour Swedish participation while the political arguments did. Its overall assessment, however, was that in the short term the arguments against EMU outweighed those in favour. It gave four reasons for this conclusion:

1. Participating in monetary union with unemployment in Sweden at such a high level involved a significant risk. Macroeconomic disturbances that could not be counteracted by monetary and exchange rate policies could lead to further increases in unemployment.

2. The fiscal situation in Sweden was still such that participation in monetary union would entail great risks.

3. Time was needed for a broad public debate on EMU so that a future decision would be perceived as legitimate.

4. In the Commission’s assessment, several countries were likely to remain outside monetary union initially as they did not meet the convergence criteria. This would reduce the political costs of remaining outside EMU.

At the same time, the Commission was more positive to Swedish participation in the longer term. It wrote: "If unemployment falls and the fiscal situation stabilises, our assessment of participation in the monetary union is positively affected." The greater the number of countries taking part, the greater the political costs for Sweden of remaining outside. Entry at a later date should therefore be the aim, but it should not occur until the economic and political conditions for participation were more favourable. The Commission’s recommendations have sometimes been erroneously described as "wait and see" when in fact they were "yes, but later".

As a member of the Commission, I largely concurred with its analysis but expressed a dissenting opinion in the report as I felt that the arguments against EMU participation outweighed those in favour in the longer term as well. Above all, I was concerned about what would happen if Sweden were to experience an economic crisis while the other EMU countries thrived, interest rates rose and the euro appreciated. Such a scenario may not seem very likely but the problems would be considerable were it to develop.

Public debate following the EMU report

The report was circulated for comment and a number of interested bodies were given the chance to respond to the Commission's arguments and conclusions. In general, organisations representing the private business sector came out in favour of EMU, as did the Federation of Swedish Farmers and the Swedish Confederation of Professional Associations. They emphasised the efficiency gains deriving from EMU participation in the form of reduced transaction costs, the elimination of currency uncertainty in Europe, and more effective competition. They also pointed out, quite rightly, that the EMU Commission had scarcely touched upon the macroeconomic advantages of greater financial integration in the monetary union. EMU enhances competition in financial markets and leads to a greater supply of financial services, they argued. The emergence of an integrated European finance market offers competitive advantages for those enterprises able to finance themselves in euros. Uncertainty over exchange rates should Sweden remain outside EMU means that small and medium sized enterprises would be unable to use this method of financing their operations.

An argument frequently advanced in favour of EMU was that it would offer a more secure guarantee of low interest rates and low inflation. Lower interest rates would make it easier to counteract unemployment. The single currency would also have a restraining effect on wage formation. A recurring argument was that the EMU Commission had overestimated the risk of "asymmetric shocks". The imbalances that had occurred in the Swedish economy, it was argued, were 'of our own making' and a result of national economic policy and devaluation. The Swedish Employers' Confederation, SAF, for instance, wrote: "In SAF's view, allowing Swedish monetary policy to be shaped by a desire to cope better with extremely unlikely disturbances would be an absurd course. Rather, monetary policy must be determined by what is good in normal circumstances, i e during the decades between any asymmetrical disturbances that may occur." Further, SAF stressed that EMU was mainly a political project and that by remaining outside Sweden would drastically reduce its chances of exercising influence in the EU.

The Swedish Confederation of Professional Employees chose not to take a position on monetary union. The Swedish Trade Union Confederation (LO) wrote in its comments: "A clear majority of LO affiliated unions are of the opinion that political and economic factors mitigating against Swedish entry in the short term outweigh other factors. Opinions differ, however, among the various LO unions." Two arguments in particular informed the LO's comments:

1. It was felt that Sweden's economy was not ripe for EMU participation in the short term. EMU would impose considerable demands on wage formation and for this reason wage formation needed reshaping prior to entry.

2. EMU had not been sufficiently discussed by the electorate and needed wider public endorsement to ensure legitimacy.

At the same time, it was felt that if Sweden managed to keep inflation at the same low levels as the rest of Europe, the economic advantages of EMU probably outweighed the disadvantages in the long term. This line of reasoning contrasted sharply with that of the Swedish EMU Commission, which emphasised the importance of pursuing a low inflation policy even if Sweden remained outside EMU.

The country's economists were divided on the issue. Opinion polls at the time showed those against EMU to outnumber those in favour, although many had still not made up their minds. Also, the EU itself was viewed with considerable scepticism during this period, especially in the ranks of the ruling Social Democrats and the Left Party. Of the parliamentary parties, the Moderate Party and the Liberal Party came out strongly in favour of EMU while the Centre Party, the Green Party and the Left Party were opposed.

The Social Democratic Government adopted a wait-and-see attitude. There may have been a number of reasons for this. The cabinet itself contained both opponents and proponents of EMU. The Prime Minister expressed doubts about the wisdom of moving towards a federal Europe in which important decisions on tax and social welfare policy, too, might be centralised. But even if the Government had been more favourably disposed towards EMU, it was ill placed to expedite a decision on membership in the first wave of monetary union. Seeking parliamentary approval would have been a perilous course. Such a decision would have sparked a furore over the question of legitimacy as the anti-EMU faction was leading in the opinion polls at the time, and would also have caused a deep split within the Social Democratic party.

Under these circumstances, announcing a national referendum on monetary union would also have been a dangerous gamble. While much of the establishment was in favour of EMU, it is difficult to see what arguments might have persuaded a sceptical public to rethink its position. The contrasting views of economic experts made it difficult to claim that EMU would inevitably lead to substantial economic benefits. Politically speaking, the Swedes, who had only recently joined the EU, were comparatively sceptical and distrustful as they saw how a growing number of decisions were being taken at European level. Public opinion was hardly ready for yet another step towards federalism.

The decision

The final decision was taken in December 1997 when the Riksdag voted in favour of a bill that stated:

"The Government proposes that Sweden should not introduce the single currency of the European Union, the euro, when the third stage of EMU begins on January 1, 1999. In the Bill the Government proposes guidelines on economic policy and EMU. The demands made on monetary policy will not lessen if Sweden remains outside monetary union. It will be at least as important to conduct a stability oriented economic policy. Sweden should keep the door open for a later Swedish participation in the monetary union. If the Government later finds that Sweden should participate, the issue will be placed before the Swedish people for judgement."

EMU has begun

Four years have now passed since that decision. What developments have occurred in the interim and how might they have affected the public debate on monetary union? The most important development, of course, is that EMU is now under way. Exchange rates were fixed and interest rates converged a few years ago. Euro banknotes are now replacing national banknotes. Obviously, it is too early to evaluate progress, but three things are worth noting.

Firstly, EMU encompasses as many as 12 countries. This is a greater number than many, among them the Swedish EMU Commission, had thought would be the case five years ago. The presence of a larger number is due partly to the fact that convergence as regards inflation, interest rates and budget deficits proceeded faster than many had expected, and that the convergence criteria were interpreted liberally. As EMU grows in size, the political costs of remaining outside grow as well.

Secondly, the value of the euro has fluctuated a good deal. The fact that floating currencies tend to vary to quite an extent is something we are familiar with, but in some quarters it had been thought the euro would prove to be a very stable currency. This is now seen to be a misconception.

Thirdly, we find that the EMU countries are not moving in step. While inflation is round 2 per cent in most EMU member countries, it is over 4 per cent in the Netherlands, Portugal and Ireland. Consequently, the monetary policy pursued by the European Central Bank (ECB) cannot suit all concerned. On the other hand, we have not yet witnessed any major problems that could be attributed directly to the common monetary policy.

Sweden's economy has improved

Another important change is that Sweden’s economic situation has improved significantly. In the mid-1990s we found ourselves in the deepest recession since the 1930s, with high unemployment, a substantial deficit in the national budget and high interest rates. Since then, government finances have moved out of the red, interest rates have fallen to the same levels as in EMU, and unemployment, too, has steadily declined. Inflation has been low ever since the crisis of the early 1990s. Based on the arguments set out in the Swedish EMU report, we can now say that we are better equipped to enter into monetary union as we are in a better position to remedy any imbalances that may occur. What is also true is that we have managed pretty well outside EMU.

Experience of floating exchange rates

In particular, our experience of floating exchange rates has been relatively favourable. A central bank reform has led to greater independence for the Riksbank and also established low inflation as the principal goal of monetary policy. For a number of years, interest rates in Sweden were considerably higher than in Germany, which indicated a lack of faith in Sweden’s monetary and fiscal policies, but today they are at roughly the same level as in EMU. In contrast to what many predicted five years ago, Sweden’s new monetary policy regime with a floating currency rate, an independent Riksbank and an explicit inflation target has led to low inflation and low rates of interest.

Meanwhile, however, we can see that the value of the krona fluctuated a good deal in the 1990s. Like the euro, the krona has turned out to be weaker than many expected. The value of the dollar climbed from SEK/USD 8.05 in December 1998 to SEK/USD 10.56 in December 2001. The euro initially fell from SEK/EUR 9.48 in December 1998 to SEK/EUR 8.24 in May 2000, before recovering to SEK/EUR 9.44 in December 2001. This confirms a known fact: that when exchange rates float, currency values vary a good deal, and often in a way that is hard to fathom.

Fiscal policy and EMU

How are imbalances in EMU to be dealt with when you can no longer resort to monetary policy measures? Alternative adjustment mechanisms such as increased nominal wage flexibility and transboundary labour mobility have been discussed, but it is abundantly clear that these mechanisms are inadequate. Consequently, fiscal policy becomes an issue of crucial importance. With a good, stabilising fiscal policy in place, the loss of monetary policy as a stabilising policy instrument is less problematic. Can we be certain, though, that fiscal policy is pursued in such a way that the economy is stabilised?

Experience in Sweden is mixed. On the one hand, what are termed ‘automatic stabilisers’ are very substantial in Sweden. As marginal rates are high, revenue declines rapidly when there is an economic downturn. At the same time, costs for unemployment benefit increase, largely paid by the state, and an active employment policy means that expenditure on labour market training, etc, increases. All these mechanisms represent a fiscal policy stimulus that offsets the decline in economic activity.

On the other hand, there have been cases where fiscal policy has not been sufficiently countercyclical. When the economy is humming and money is pouring into state coffers, it is difficult to agree on the necessity for cuts and tax increases. In a recession, budget deficits may become so large that they necessitate a squeeze rather than a stimulus. Overheating at the end of the 1980s and the crisis of the early 1990s is an illustration of this, and similar examples have been seen in other countries. An element of uncertainty exists, therefore, concerning how well fiscal policy can replace monetary policy as a stabilisation policy instrument. The issue of stabilisation policy in EMU is currently being studied by a special committee in Sweden.

Another question concerns the extent to which monetary union may lead to a centralisation of EU fiscal policy as well. This is a politically sensitive issue as many Swedes are sceptical to the idea of further steps towards a United States of Europe. Moves towards a European fiscal policy might also be considered a threat to ‘the Swedish model’ with its high taxes and well-developed social welfare safety net. (Quite a few

Swedes undoubtedly see this as a positive effect of greater European integration.) The EMU Commission took the view that no great change was likely – at least in the medium-long term. Monetary policy may be perceived as a technical problem, but matters such as taxes, transfers and central government activities are far too sensitive for national parliaments to release their hold on them. The question of coordinating fiscal policy will however be a subject of intense discussion in the EU over the next few years.

Will Sweden join EMU soon?

Public opinion on EMU has swung back and forth in recent years, which probably reflects the considerable uncertainty that most people feel about this issue. Today, those in favour of Swedish participation slightly outnumber those against. How public opinion will develop in the future will depend on economic developments in both Sweden and the EMU zone, which will either reinforce or weaken the economic arguments for or against. But more important still will be the political attitude that Swedes adopt towards the EU and its goal of "an ever closer union".