Kjell-Olof Feldt, EMU — the best choice for Sweden (1998)

Caption: In 1998, Kjell-Olof Feldt, Chairman of the Board of Governors of the Sveriges Riksbank, Sweden's central bank, sets out the arguments in favour of his country's participation in Economic and Monetary Union (EMU).

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EMU — the best choice for Sweden

by Kjell-Olof Feldt, Chairman of the Board of Governors, Sveriges Riksbank

Introduction

Sweden's relationship with the European Union (EU) has moved into a new phase. With the Social Democratic Party executive's decision to advise the party to reject membership of the economic and monetary union (EMU), we must assume that Sweden will for an undefined period of time be unable to bring to completion its membership of the EU by accepting economic policy integration. The party executive put forward two reasons: EMU is "under present circumstances" an uncertain project and there is not sufficiently strong public support for Swedish membership.

The explanation for this decision demonstrates quite clearly that it is the poll figures which have decided its content. Sweden should naturally ensure that it retains the maximum freedom of action in order to join later - if it is then believed that membership of the currency union is "the best thing for Sweden". But the decision is being put in the hands of the people: it must be preceded by a new general election or a referendum. Anyone who wishes to be able to influence the next stages in this process will have to spend some time shaping public opinion. It is only when it appears more or less certain that the Swedish people in general and the Social Democrats in particular are strongly in favour of abandoning the krona in favour of the euro, that a Social Democrat Party executive - and government, if that is the case - will be prepared to ask the people for an answer.

This article is an attempt to provide some ammunition for those who claim that membership in EMU is "the best thing for Sweden".

EMU and EU's history

Regardless of one's attitude towards a European currency union, most people probably agree on one issue. The union is a unique experiment with an advanced overall purpose - to create financial stability in the European Union's member states. With a single currency one destabilising factor of some significance will disappear directly, namely fluctuating exchange rates. And with a single monetary policy differences in nominal interest rates will also disappear. But the aim is to go further. The aim is for the single currency to be strong and stable and for real interest rates to be the same throughout the entire area. This requires inflation in all the participating countries to be held down, and public finances to be in good shape in the long term with limited borrowing and a manageable national debt.

In order to properly understand the arguments for such far-reaching economic policy integration, we can learn something from the history of European economic co-operation.

When the original six EEC states met in Rome in 1957 to sign the foundation treaty for the EEC, economic growth and free competition did not play the principal role. Their reason for setting up the European Economic Community was to put an end to the conflicts between west European countries, particularly between Germany and France.

To achieve this goal they planned to bring about far-reaching economic integration. This would not only lead to a strong, mutual interdependence between the countries, but would also make possible a more closely harmonised economic development - no country should be left behind in the process of economic growth that had begun after the Second World War. Economic revanchism and yawning gaps in living standards should be eliminated as possible causes of political conflict.

But developments did not completely follow the plans. Thirty years after the formation of the EC, in the mid-1980s, very little had happened in the form of economic integration.

A customs union had been set up, which involved internal freedom from customs controls and a common tariff barrier in relation to the rest of the world. But the customs union in itself did not create any significant degree of economic integration and mutual inter-dependence. This can be illustrated by the fact that the intended harmonisation of economic developments in the original six EC countries was still elusive. West Germany emerged as Europe's economic great power, while France was definitely lagging behind.

The EC also instituted a common agricultural policy. This has sometimes functioned as a political 'putty', but it has also given rise to numerous conflicts, especially between Great Britain and the other EU countries. From an economic point of view, it must be seen as a burden to the Community and as an obstacle to economic growth in general.

The single market

And that is about as far as things had progressed after 30 years, i.e. towards the end of the 1980s. In certain areas we had actually made more progress in our Nordic collaboration. For example, we had abolished passport controls and created a common labour market.

However, there was a big jump forward when the decision was taken to create the single market by 1992. Now the Treaty of Rome's economic integration would finally be achieved.

This decision was seen by many as the final step in the efforts to realise the vision: to create a genuine economic community, built on a single market for goods, services, capital and labour, to introduce common, i.e. supranational, institutions which could help to bring about more homogeneous economic development in all member states.

Ever since the dismantling of national borders in Western Europe began in favour of a free exchange of economic products and services, i.e. trade in the broader sense, there have been attempts to bring about stability in exchange rates between national currencies. There were two reasons for this; to reduce the uncertainty in trading relations which resulted from fluctuating exchange rates and to prevent disturbances to competition due to devaluations.

The EC-EU has also tried various types of currency policy collaboration. This began with the currency snake, i.e. a number of currencies whose exchange rates were fixed in relation to the German Deutschemark. However, this was not an EC institution and even Sweden was part of it until 1976. At the beginning of the 1980s the snake was enlarged to become the Exchange Rate Mechanism (ERM) and the European Monetary System (EMS). But the ERM and the EMS did not provide what was sought, viz. monetary stability in the form of fixed exchange rates between the European countries as well as inflation and interest rate convergence.

The lesson to be learnt from these failures is that it is not enough to have agreements on exchange rate stability between national currencies. Achieving stability requires far-reaching harmonisation of the factors which determine movements in the most mobile of production factors, i.e. capital. And this is mainly a question of monetary magnitudes, such as interest rates and return on capital. But it has proved to be impossible to achieve this on a lasting basis, without a common monetary and currency policy.

The EMU Project

Previously the state, i.e. the government and parliament, could at least believe that it determined central economic policy parameters, such as the exchange rate and interest rates, via its central bank. It also felt it could control the level of capital formation in industry, in both cyclical and geographical terms. But the internationalisation of markets and companies has radically changed these conditions. Any government that wishes to influence interest rates and exchange rates can, at best, accomplish this by indirect means. And in this context, the means involve more diffuse elements, such as general confidence in the state's capacity to keep public finances under control and to hold down inflation. Nor can the state do much more to determine the level of industrial investments than to keep industrialists and investors in a good mood: capital is free to move to those parts of the world where it can earn a healthy, long-term yield - or where there is the hope of a quick profit.

Investment decisions are determined not only by monetary magnitudes, such as interest rates and return on yield, they are also influenced by many other factors. One of these is the existence of political risks - e.g. in what shape a country's public finances are. If public finances are weak and the central government debt is high, unpleasant surprises could be just around the corner - abrupt interventions in the form of tax increases or other restrictions. Or else inflation, which will reduce the exchange rate and turn a profit into a loss.

Over the past 20 years western Europe, including Sweden, has not had the benefit of conditions which made the area attractive for long-term, strategic investments, investments in high technology, or the know-how intensive development of industry. In addition to the unavoidable commercial risks, there have been quite a few political risks: currency instability, soaring budget deficits, and difficulties in converting the idea of a common market into reality with any great force.

It is easy to see that western Europe has lost out in the competition for strategic investment capital and innovative, creative formation of new enterprises. It has not been enough to succeed in the battle against inflation. Economic growth has been low, unemployment has soared, and public finances have been continually deteriorating.

The EMU project has evolved out of this type of insight and experience. The main purpose of the project is thus to make the entire EU area - not just a few parts of it - attractive to investors and suitable for industrial growth. And the greatest attraction shall come from two sources:

• access to a large, integrated market which will also involve few risks, thanks to a high degree of monetary stability;

• low inflation, low interest rates and member states with strong public finances, who will not announce unpleasant surprises in the form of new taxes and duties.

Sweden and EMU

According to a very widely held belief, Sweden needs a long period of economic growth and rising employment. But there is a risk that discussions as to how this should be brought about might focus too much on one solution - raising demand for cheaper services.

Of course this is a necessary - although not very appealing - aspect of the solution to the unemployment problem. But without a robust manufacturing industry and a high quality service sector, which are expanding on foreign markets and in international competition, there will be no growth to create the necessary demand. It is in those sectors that the considerable added value and the greatest contributions to the growth in domestic demand must be created.

Some people prefer to blame our economic problems on excessive dependence on international markets. But in my opinion, it is rather the reverse - an unduly large part of the Swedish economy has become dependent on domestic factors which are growing weakly or even declining: viz. the public sector, the building industry and private consumption. Consumers' real incomes and the propensity to consume are being constrained by the slow growth in productivity and the reconstruction of public finances.

Sweden's economy therefore needs to increase its international dependence in the form of stronger integration with foreign markets, an increased inflow of capital for long-term strategic investments, and imports (and exports) of new technology and competence. The most serious thing that could happen to us is not stagnating consumption; it would be if numerous activities and ventures which could increase growth and create new job opportunities, i.e. capital investments, research and development activities, the formation of new enterprises, and innovations, are being hampered by the fact that the process of international integration is being made difficult or being broken off.

The Federation of Swedish Industries has demonstrated in a commendable way the consequences for industrial development if Sweden were to remain outside the deepening of the European integration that the EMU project entails (Ems, 1996; Industriförbundet, 1997). If this were also to mean that the Swedish economy relapsed in a number of respects into its earlier financial instability, with inflation and wide fluctuations in the exchange rate and real interest rates, yet another risk factor would have to be taken into account in decisions on investments and industrial development.

Even those who do not share the opinion that greater internationalisation is necessary agree that Sweden cannot afford under any circumstances to lose the financial stability which we are now recovering. Indeed, if we remain outside the currency union, we must outperform the EMU countries with regard to inflation and the state of our public finances. We would therefore have to pursue an even more stability oriented policy than the EMU countries are likely to pursue.

Mistrust of EMU

So why do so many people argue that Sweden should remain outside EMU or, which appears most common, that we should at any rate wait to join - even if the Swedish economy and Sweden's public finances satisfy the convergence criteria for membership stipulated in the Treaty of Maastricht?

As I understand it, there are two completely different ways of reasoning. The first is that EMU is a far too risky venture for Sweden to be able to join; the second is that Sweden is not yet ready to join a currency union.

Those who have no confidence in EMU's capacity to function in a way that would satisfy Swedish interests also base their arguments on different principles. One is that the aim of financial stability will make it impossible to pursue an economic policy that would promote full employment. This impression is probably not based (with the odd exception) on the belief that employment would benefit from high inflation. It is rather a case of fears that the demands made on fiscal policy in the stability pact will reduce the freedom to pursue a policy which stimulates demand in situations where this might be motivated, e.g. in an economic recession, or even force a government to tighten its fiscal policy, just when the opposite is needed.

A little reflection should tell us; however, that this type of situation can only arise in a country whose fiscal policy permits large deficits on public finances, even when the economy is growing at its fastest. Under the terms of the stability pact, the deficit shall amount to at most 3 per cent of the gross domestic product (GDP) although it may temporarily exceed this figure, granted that corrective measures are taken within a year.

The Swedish government and a majority in parliament have for their part established the goal that public finances should show a surplus in the long term, which is motivated by the need to reduce the public sector debt, which now amounts to almost 80 per cent of GDP. And as the EU countries' total public debt ratio is around 75 per cent, the only reasonable goal in the long term should at least be to keep public finances in balance. This should provide ample scope for fiscal policy measures to stimulate the economy in times of recession, without these clashing with the stability pact.

The other reason for having no confidence in the EMU project is of the opposite nature. The scenario in this case is that from the very beginning EMU will include countries whose chances of being capable of satisfying the financial stability criterion vary far too widely. The risk of this will increase as more countries join, especially if this is made possible through a relaxation of the convergence criteria. The result could then be a weak euro, which would compel the European Central Bank (ECB) to pursue a characteristically high interest policy to underpin the euro and keep inflationary tendencies at bay. This would lead to worse conditions for growth and employment, which in turn would make it harder for member states to satisfy the budget policy criteria in the stability pact. And this would lead to such great economic tension and political opposition that the entire project would have to be scrapped or fundamentally restructured.

On the part of the leading EU countries, the idea of relaxing the convergence criteria has been completely rejected. But the course of events during the winter and spring of 1997 has led to increasingly frequent rumours that some relaxation of the criteria cannot be discounted. The reason for this is said to be the inability to withstand the political pressure to create a "Super EMU" right from the beginning, or alternatively that it must be done so that the currency union can start up at all according to plan on January 1, 1999.

It is difficult to assess the credibility of these rumours at the time of writing, in June 1997. But regardless of what economic policy conditions a currency union is given, one conclusion is already certain and inevitable. As a member of the EU, Sweden has a very definite interest in EMU being given the best possible conditions to achieve its goal, i.e. financial stability in the Euro area. Our high degree of dependence on both interest rate developments and economic growth in Western Europe means that a weak EMU with high interest rates and unstable financial conditions would create a similar situation in the Swedish economy. And we cannot reduce this dependence to any great extent by refraining from joining EMU. Whatever happens, the Swedish government should do all that it can to ensure that EMU only includes those EU countries which have both the economic capacity and the political determination to satisfy the financial stability criteria in general and the criterion for disciplined public finances in particular.

Wait and see?

The second line of argument - that Sweden is not ready to enter a European currency union - was given its most carefully thought out basis when the official committee on EMU and Sweden (The Calmfors Committee) arrived at this conclusion (Calmfors, 1997). The committee's report highlights a number of problems which exist in the Swedish economy. Until these are solved, it would be unwise to join EMU.

The report considers that there are two associated structural problems in particular - high unemployment and the far from adequately functioning labour market, in particular as far as wage formation is concerned. This is still an inflationary factor, while the wage structure needs to be better adapted to the conditions on increasingly integrated markets. The Calmfors Committee believes that the problems due to wage formation cannot be solved without reducing unemployment at the same time - otherwise employees and their union representatives will not agree to reform the wage formation process to allow wages to be more closely related to labour productivity and the individual company's market conditions.

But why should it be easier to reduce employment before we join EMU? Well, according to the Calmfors Committee, Sweden will be in a far better position to pursue a more expansive monetary policy and generate higher domestic demand if it remains outside EMU.

The Governors of the Riksbank, in their comments on the report, expressed severe doubts that this was possible. In our view, there is a distinct risk that Sweden, if it pursued such a policy, would lose much of the credibility it has so carefully built up over the last few years, since this would make it extremely difficult to avoid the interpretation that "a more expansive monetary policy" would also tolerate a weaker currency. And this interpretation will have fairly immediate consequences for inflation expectations and thereby also for interest rates. We may, in other words, gain the wrong sort of stimuli - greater freedom for wage rises and less interest in capital investments that would generate employment.

It would be better to reason as follows. Regardless of EMU, Swedish wage formation needs to be adapted to the international conditions on which industry operates, if employment is to be kept up and unemployment brought down. We have already tried (on no fewer than seven occasions) the devaluation method, and it has not worked. If it is to work, it must be done by adapting nominal wages and changing the wage structure. If we joined a currency union, this would be the natural solution. This does not mean that it would be either painless or carried out rashly. But no-one can any longer believe in the illusion that there are other, painless and speedy routes to the goal, i.e. a functioning labour market and an industrial and commercial sector which can create new jobs.

The only power we would be depriving ourselves of with any certainty as members of a currency union is the right to destroy the value of our currency and to mismanage our public finances. This right has not proved to be particularly valuable. We would rather, as part of a financially stable currency region, obtain greater scope for exercising our democratic rights to more productive ends, how wealth should be created and the living standards of our citizens be maintained and improved.

I believe that if we do not join EMU we will have less scope in this respect. We will be even more closely watched by the international capital market, which will constantly be on the lookout for signs of new weakness: signs that inflation is returning, that we are once again mismanaging our public finances. The price could be that we could be compelled to pursue an even tighter fiscal policy, to be even more sensitive to the capital market's demands than if we were a member of a larger economic policy community.