Let me start by thanking for the invitation to speak here. Let me also say that I am slightly puzzled by the order of presentations. It is not obvious that one should start a seminar on ”Perspectives on European integration”, taking place in Denmark, with a speech on ”Sweden and EMU”. But I guess that, as a Swede, I should be flattered by the interest devoted to Sweden.

Anyway, I shall try to live up to the task of giving perspectives on the Swedish position vis-à-vis the EMU. I want to stress that I do this as an independent and irresponsible academic, and not in any official capacity.

I shall structure my speech in the following four parts:

1. I shall repeat the background to the Swedish decision not to join in the first round in 1999.
2. I shall give an account of the present Swedish position.
3. I shall give my judgement on this position.
4. And finally, I shall make a forecast of when Sweden is most likely to join.

Let me start with the background of the Swedish decision not to join the EMU at the start in 1999. I guess I bear some responsibility for this as the chairman of a government commission that in 1996 recommended the government to follow this course of action.

The government commission acknowledged a number of efficiency gains of a common currency: lower transaction costs, elimination of currency risk within the euro area, more price transparency, a more efficient capital market and so on. We also acknowledged that a Swedish decision not to join would mean political costs in terms of lost goodwill and smaller influence at the European level. In short, it is an effective means of reinforcing the bad reputation of the Swedes as "unreliable and half-hearted Europeans".

But at the same time, we emphasised that EMU membership is likely to have a stabilisation policy cost because asymmetric macroeconomic shocks could at times lead to very different cyclical developments than in the rest of the euro area. Like in Denmark (and also in Britain, Ireland, and Finland), the business cycle in Sweden has in the past often developed rather differently than in the core EMU countries. Compared to Denmark, the stabilisation cost of giving up the own currency is likely to be much greater for Sweden, since we have chosen a flexible exchange-rate regime instead of ERM membership.

The government commission put a lot of emphasis on this stabilisation cost of joining the EMU. One reason for this was the sad state of public finances at that time with large budget deficits. This meant that fiscal policy had to be geared exclusively towards reducing government debt, which gave no room to use fiscal policy for stabilisation purposes. Another important consideration was that we felt that the risk of larger macroeconomic variability in the EMU would be very problematic in a situation with high unemployment to begin with: in the case of serious asymmetric shocks that cannot be countered by monetary policy, we risk ending up in a very deep recession with totally unacceptable unemployment levels.

When the Government Commission weighted the different arguments together, it took the stand that Sweden should wait with joining the EMU until we had achieved a better functioning labour market and government finances were in better shape. The recommendation could be described as: *Not now, but probably later*.

The decision taken by Parliament in 1997 was also that Sweden should not join the EMU in the first round. It was a decision that is usually described in the Swedish debate as: *No, not now*. As a policy adviser, I would like to think that this decision was taken because politicians listened to the advice of economists. But, to be honest, I do think that our arguments played a rather limited role. The main political argument was that the Social Democratic Party was split on the EMU issue and that public opinion at the time was highly sceptical to the EU in general and the EMU in particular. The judgement was that EMU membership entailed too large political risks for the Social Democratic Party and, in that situation, our report was very handy by providing an economic justification for a decision taken on other grounds.

What is the present situation? It has changed radically as the Social Democrats took a decision on an extra party congress this spring that Sweden should in principle join the EMU when the time is right. In the liturgy of the Swedish EMU debate, the Social Democrats have moved from the earlier position of *No, not now* to *Yes, but not now* or perhaps even *Yes, but later*. At the same time, the Christian Democrats, who are the second largest opposition party, and who were earlier sceptical to EMU membership, have also opted for it.

In the Social Democratic decision, two, or really three, requirements for Swedish membership are set up:

- Wage formation should be functioning well.
- The business cycle should be in phase with that of the EMU countries.
- New instruments of stabilisation policy, which could make up for the loss of domestic monetary policy, should be developed.

I want to comment on these conditions? How reasonable are they? How likely are they to be met and, if so, when?

Let me start with wage formation. How should one view this condition? It is not the case that there is more freedom to raise wages outside the EMU than inside, as some people believe. Sweden now has an inflation-target regime, which means that the *Riksbank* is obliged to raise interest rates – and make the krona appreciate - if domestic wage increases threaten the inflation target of 2 per cent. I believe that this works as a strong disciplinary force on trade unions. They know that they must hold down wage increases if they are not to be punished by interest-rate increase on the part of the central bank. In fact, the LO (the union confederation for blue-collar workers) has run large internal campaigns among its officials on the need to adjust wage claims for this reason. We have obtained a policy game that very much resembles the traditional policy game between the Bundesbank and trade unions in Germany.

I see a risk that this disciplining force will disappear in the EMU. If we join the EMU, Swedish trade unions need no longer fear that excessive wage increases will trigger interest-rate reactions. In my view, this creates a risk of higher wage pressures in the EMU, which in the end may have to be balanced by higher unemployment. So if one looks at it this way, it is very reasonable to require low wage increases as a precondition for EMU membership: if the incentive for wage restraint can be expected to weaken once we are in the EMU, then we should really see to it that wage setting is functioning well before we join.

The argument I have advanced goes against much of the conventional wisdom, which says that EMU membership would discipline wage setting. I believe that argument is basically wrong in the Swedish setting, because it does not acknowledge that the granting of independence to the Swedish *Riksbank* has fundamentally changed the monetary policy regime to what appears to be a very credible inflation-target regime. As you can see, Sweden has been very successful in holding down inflation in recent years. The fact that the long-term interest-rate differential to Germany has almost disappeared – and that we are now below Denmark and several of the euro countries – bears witness of this credibility gain.

One can also make another interpretation of the argument that the wage setting system must be functioning well before we join the EMU. As you can see from my diagram, Swedish unemployment has been falling in the last two years and is expected to continue falling rapidly. This is especially true if one looks at what we call *total unemployment*, that is the sum of open unemployment and participation in active labour market programmes.

It is still an open question to which extent this fall is a cyclical development and to which extent it represents a fall in structural unemployment. If it is mainly a cyclical fall, so that actual unemployment is falling below the structural rate, then a wage inflation process will start again and unemployment will ultimately bounce back again. With this interpretation, excessive wage increases would be an indication that the present rise in employment is not persistent and that we have not really solved our labour market problems. This argument is very close to the government commission's argument that we should not join the EMU until we have a stable situation of reasonably low unemployment.

What prediction should we make about future wage growth? This is an area of great uncertainty. There are a number of positive signs. Wage growth has come down, as you can see from my diagram. A new kind of bargaining framework with the aim of ensuring international competitiveness has been agreed by a number of industry unions and employers. But at the same time, more fundamental labour market institutions like unemployment insurance, employment protection laws, the right to go to labour market conflicts and regulations promoting union membership have not been reformed, and tax pressures have not been much reduced. There have been no labour-market reforms of the type that occurred in the Netherlands, and to some extent in Denmark as well.

For this reason, there is in my view a strong argument to *wait and see* how wages will develop over the next years before taking a final decision to join the EMU. My worry is that we will see a creeping process where wage growth increases very gradually as labour shortages develop in the economy.

Let me the go to the *second requirement* for EMU membership: that the Swedish business cycle should be reasonably well synchronised with the EMU countries. It is an argument that is close to one of the requirements put up by the British government. It has been criticized on the ground that the EMU decision is a very long-run one and that the short-run cyclical position therefore should not matter very much. I do not share that view.

If there is something we have learnt during the last twenty years it is that short-run macroeconomic disturbances can have very long-lasting effects. I am thinking then of the productivity slowdown in the 1970s and the disinflation and high real interest rates in the 1980s which caused very persistent unemployment rises in most EU countries, including

Denmark. The rises in unemployment in Sweden and Finland in the early 1990s are other examples of how cyclical demand disturbances can raise unemployment for a very long time. So for this reason, I believe there is a strong argument for not entering the EMU in the wrong cyclical phase.

What does this mean in the Swedish context? At present, Sweden seems to enjoy a stronger cyclical upswing than the euro area. The GDP is forecast to grow by around 4 per cent this year and around 3 per cent next year. I see a risk that the situation will develop into a serious overheating of the Swedish economy.

This fear is underlined by the fact that fiscal policy is not as restrictive as it should be in this phase of the business cycle. On the contrary, large tax cuts will be made both this and the next year that will contribute to demand pressures. The explanation is political: there is a strong pent-up demand for looser fiscal policy after several years of consolidation efforts, which makes it impossible to pursue restrictive policies in the present situation: if one has for years argued for budget cuts because of concerns over rising government debt in a recession, it is very difficult to explain to ordinary people that we should make further budget cuts in an upswing when the budget has moved into surplus, which is the present situation.

In this situation, I think there is a great value for Sweden of having a monetary policy of our own. In my view, it has been a great advantage that the Swedish krona has appreciated relative to what is a likely final conversion rate vis-à-vis the euro. This has helped to dampen the upswing. If the tendencies towards overheating grow stronger, as I fear, it will be very important for us not to give away monetary policy as a domestic stabilisation policy tool in the next few years. I believe this is crucial if the present upswing is to result in a persistent reduction of unemployment. If the economy is allowed to overheat, the result will be excessive wage increases and a return to higher unemployment levels again, something that may be happening over the coming years in Ireland, which is in a situation similar to the one that I want to avoid.

Let me then move to the *third criterion*: that we should have alternative policy instruments that can be substituted for domestic monetary policy when we join the EMU. I find this a very reasonable argument, too. There is very little support for the idea that EMU membership would make money wages much more flexible than in the past. And labour will certainly not become very much mobile between countries just because of the common currency. So there is a need for alternative policy instruments in the EMU if a country turns out to get a very different cyclical development than the other euro countries.

The only realistic alternative policy instrument that is available is in my view fiscal policy. If large macroeconomic fluctuations cannot be evened out through monetary policy it must be done through fiscal policy. And if fiscal policy is to be used, there must be sufficient room for manoeuvre. This adds a strong argument for a more restrictive fiscal policy in the next years. There must be a large enough surplus so that there is room not just for the automatic stabilisers to work in a downswing, but also for discretionary tax cuts – especially cuts in payroll taxes as a way of affecting international competitiveness – if we were to be hit by a serious recession again.

The government has set a goal of a budget surplus of 2 per cent of the GDP over the business cycle. I am not sure that this will be enough. And I am not sure that we are hitting even that target. It is true that the projected surpluses for this year and the next are around 3 per cent, but if this occurs during an upswing, the average surplus over the business cycle cannot certainly be 2 per cent. We would need much bigger surpluses now to prepare for the future.

So, to sum up my discussion of the requirements that have been formulated for Swedish EMU membership, I find these requirements very reasonable. I believe that they provide good reasons for still waiting a few years before joining the EMU. I would like to see us through the present boom without a new round of wage inflation and be convinced that there has been a fall in structural unemployment before Sweden becomes a member of the EMU. I would also like to see a more responsible fiscal policy.

How should one judge the possibilities that we meet the criteria that have been formulated? I do believe that there is a fair chance that monetary policy can handle the situation even if fiscal policy is not restrictive enough.

But as I said before, the economic considerations will probably not play so large a role for a Swedish decision to join the EMU. It will mainly be a *political* decision. It seems as if the Social Democratic leadership has decided that Sweden should in a few years time join the EMU. I think they will go for it as soon as they believe that they can win the referendum that has been promised, and do this without splitting the party and losing votes to the Left party (the former communists) and the Greens, who are both opposed to EMU membership.

The timing of a referendum probably depends both on what happens in other countries and on domestic considerations. I have all the time believed that a Swedish decision to join the EMU would be taken after a British decision. But the prospects of British entry now seem more uncertain than ever. So it is much less likely now that Sweden will wait for a British decision. A yes in the Danish referendum this autumn will probably have an important effect. The entry of Greece may have some influence, too, although I am not sure in which direction.

Then, there is the question of timing of a Swedish referendum in relation to the next general election, which will take place in the autumn of 2002. The Social Democrats will at any cost try to avoid having EMU membership as an issue in the 2002 election. So they could either go for a referendum in 2001 in good time before the election to get rid of the issue. Or they could go for a referendum some time after the general election in order to disarm the issue in the election campaign, which was a successful strategy when there was a referendum about EU membership in 1994.

The risk for the Social Democrats of having the referendum in 2001 is that voters, who are dissatisfied with a decision to join the EMU, will go to the Left Party and to the

Greens. One should not rule out completely a referendum next year, but my forecast – on purely political grounds – is that the referendum will be rather soon after the 2002 election. Looking at the economics of it, I do not object too much to such a timing, even if I would prefer a somewhat later date in order to be more certain that the labour market situation has improved permanently.

If there is a referendum in 2002, when will Sweden join the EMU? I find it neither likely nor desirable that Sweden should join the ERM system before a referendum. The Swedish government would probably be afraid that such a decision would backfire in the referendum, as many voters would take it that the decision to join the EMU had already been made. And there is also the economic argument that we should have as few restrictions as possible on monetary policy in the present cyclical situation. So I would expect an ERM entry first after a yes in a referendum.

Then there is the question of how long a period in the ERM that would be required before we are allowed into the EMU. If the British want to join at about the same time, the period might be significantly shorter than two years, as I do not see how one could get the British to stay in the ERM for any prolonged period. If there is anything that the British dislike even more than the EU and the EMU, it is probably a fixed exchange rate. If it is only Sweden that is to join the EMU, we would probably, like Italy and Finland, have to wait at least one and a half year before joining, so we would then be talking about perhaps the summer of 2004.

A final question: Will Swedish voters in the end vote yes to the EMU? At present there is a small lead for the no side, but public opinion has been very unstable. Support for the EMU went down a lot in connection with the firing of the EU commission last year, so such developments may be quite important. Exchange-rate developments for the euro might matter, too: a weak euro would probably undermine public support, unless Swedish industry could make a convincing case that the strong krona makes Swedish products uncompetitive. (This would by the way be the opposite argument to the one that has been used earlier, when the claim has been that the Swedish krona would become too weak outside the EMU.)

In any case, I think we will se a rather strange campaign situation in a referendum on EMU membership. On the one hand, there will the bulk of Social Democrats claiming that we should join the EMU in order to rein in market forces: the need to find a counterbalance towards global capitalism and disturbing capital movements seems to be the campaign theme that the Social Democrats are going for.

On the other hand, there will be the liberal parties arguing that we should join the EMU in order to rein in the Social Democrats and get guarantees that we will follow more market-oriented policies in the future. So one should be in favour of EMU membership both if one wants more capitalism and if one wants less of it. I guess this will make the choice quite easy for voters, but I do not think that they will become very enlightened by the referendum process.

Let me end with a final reflection. Is it good or bad that Sweden has waited with joining the EMU? One can discuss the economics of it at length. The view I have advanced is that there has been and still is a strong precautionary reason for waiting. The question that one is usually asked in this context is why there should be a special need for Sweden to wait for this reason, when others could join from the start. Of course, there is no specific such reason; rather the proper answer is that there a strong case for thinking twice before you do what others do, if you are uncertain that they do the right thing.

But I think the main advantage of waiting to join the EMU has been political. After Sweden joined the EU in 1995, there was a very strong backlash in public opinion. Part of the reason was that EU membership was oversold: the economic benefits were vastly exaggerated in the referendum campaign. When the promised benefits did not materialise, this provoked a very strong reaction against EU membership in general. It would have been very unfortunate if we had had a new referendum on EMU membership in say 1997 with again very exaggerated arguments about the benefits, which could not stand up to reality. We could just not afford to take such a risk because of the harm it could have done to the attitudes in Sweden towards European integration in general.

Now, we have had several years of public discussion, where it has at least become known that the EMU issue is a very complex issue, where economists and political scientists have very divided opinions. I think this has to some extent reduced the risk that the EMU project is seen as an elitist project that is pressed upon ordinary people by the "establishment", if I may use this term. So in the long run I believe that the slow process through which Sweden seems to be entering the EMU will strengthen public support in our country for European integration. I see this as an important benefit. Thank you.