

SWEDEN'S PATH TO THE EUROZONE



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Word count: 1988

Introduction

In this coursework the following issues will be discussed:

- The Swedish government's official strategy regarding the euro adoption.
- The country's progress towards fulfilling the Maastricht criteria for Eurozone membership.
- Would Sweden be a good candidate for Eurozone membership in the point of view of the theory of optimum currency areas (OCA).
- What costs and benefits Sweden will encounter if entering the Eurozone as well as advantages and disadvantages of not entering the Eurozone.

Sweden's official strategy towards euro adoption

In 1997, the parliament decided that Sweden would not enter the European Monetary Union when it was started in 1999 (based on the "Calmfors report"). In the referendum on the 14th of September 2003, 42.0% voted for introducing the euro in Sweden while 55.9% voted against. 82.6% of all eligible voters participated in the referendum². Sweden has, due to the result, no current target date for entering the Eurozone to join the other twelve countries which have already entered.³

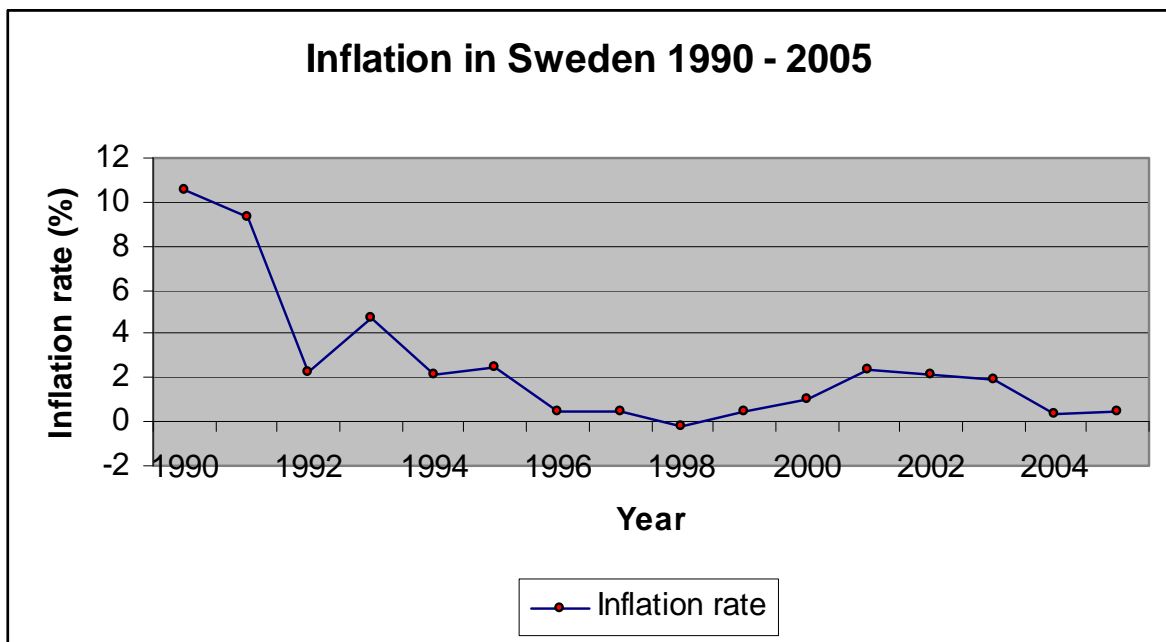
The Maastricht criteria

1991, the Maastricht Treaty is signed. It states what specific conditions a country's economy has to be in to be able to join the union. This is to avoid friction between the countries.

1. The country's inflation rate cannot be higher than 1.5% over the average of the three candidates with the lowest inflation.^{4 5}

According to the convergence report in 2004, the average inflation rate in Sweden between September 2003 and August 2004 was 1.3%, which is much lower than the 2.4% that was the upper limit. An inflation target of 2 % was introduced in 1993 which the central bank aims to keep within 1%. Inflation has been low since 1994; it did however exceed a 3% mark at times during the period 2001-2003. This was due to the depreciation of the krona which led to higher import prices and a sharp increase in the price of electricity.⁶ The inflation has been around 0.5 % during 2004 and 2005 and is currently (January 2006) 0.9%.⁷

Figure 1

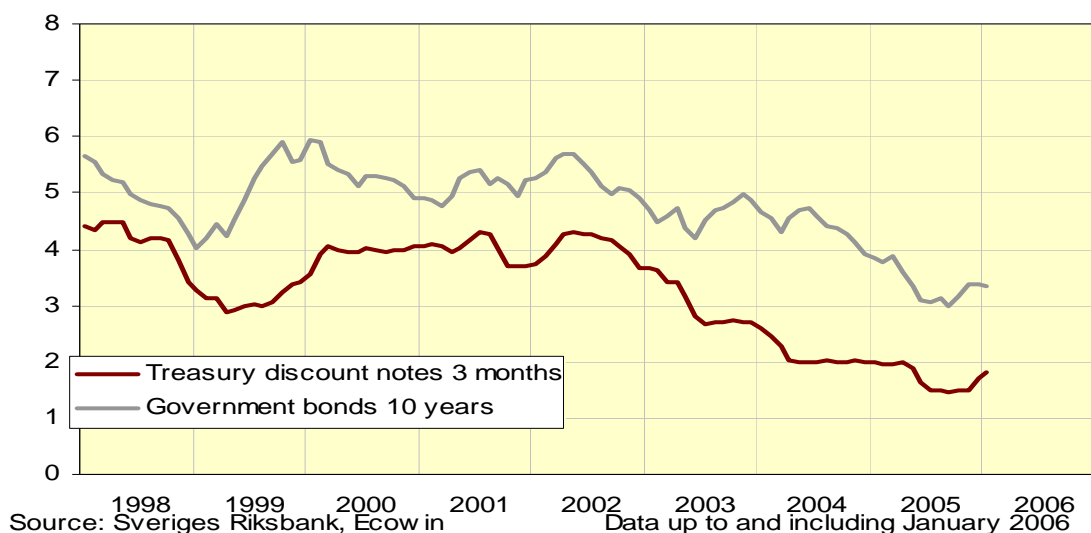


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2. The long-term interest rate cannot be more than the average in the three “low-inflation countries”.⁹

The long-term interest rate could not, according the 2004 convergence report, exceed the reference value for the interest rate criterion which was 6.4%. The long-term interest rate in Sweden during this period was 4.7% on average. The interest rates has since then declined.¹⁰

Figure 2



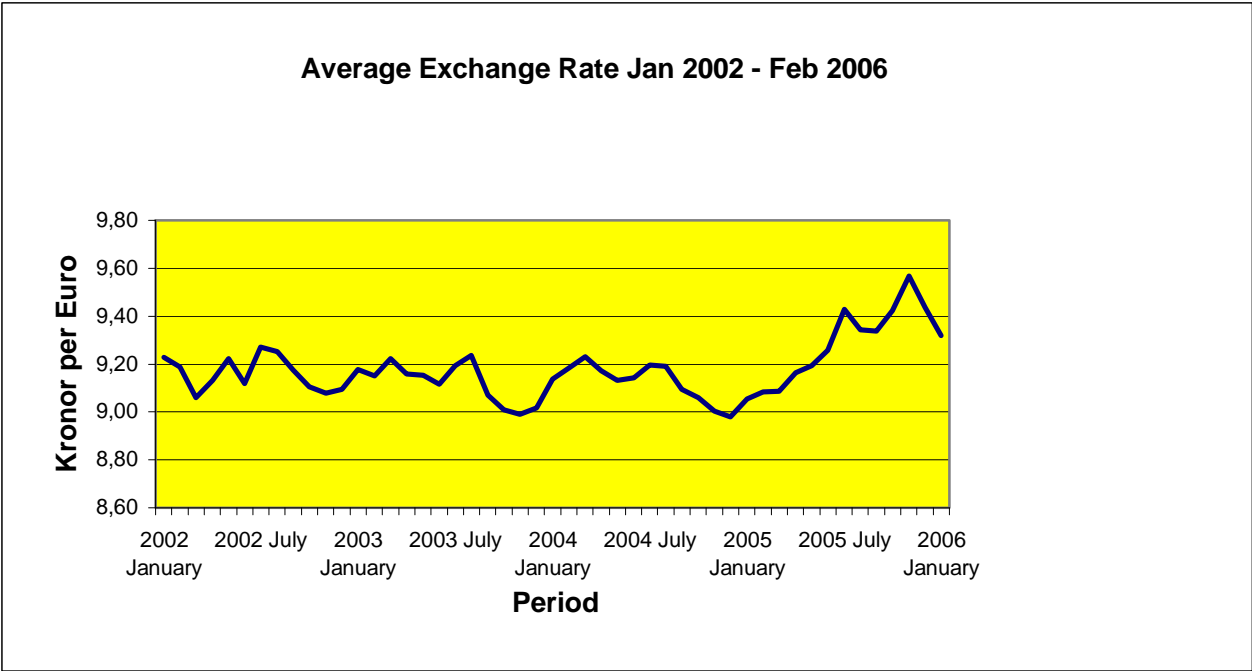
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3. The Country must have joined the exchange rate mechanism of the European Monetary System and cannot have experienced devaluation during the two years before entering the monetary union.¹²

In 1998, Sweden signed an agreement on the operating procedures for the Exchange Rate Mechanism, ERM II, but has still not joined it. In the absence of an ERM II rate to compare with, the 2002 average exchange rate against the euro, which was 9.105 kronor per euro, has

been used as a benchmark in the 2004 convergence report. The krona is thought to not have been stable enough against the euro and during the second part of 2005 has deviated from the benchmark even more.^{13 14}

Figure 3



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- 4. The Government budget deficit can not exceed 3% of the GDP. If it does it should either be exceptional and temporary or be continuously and substantially declining towards 3%.¹⁶**

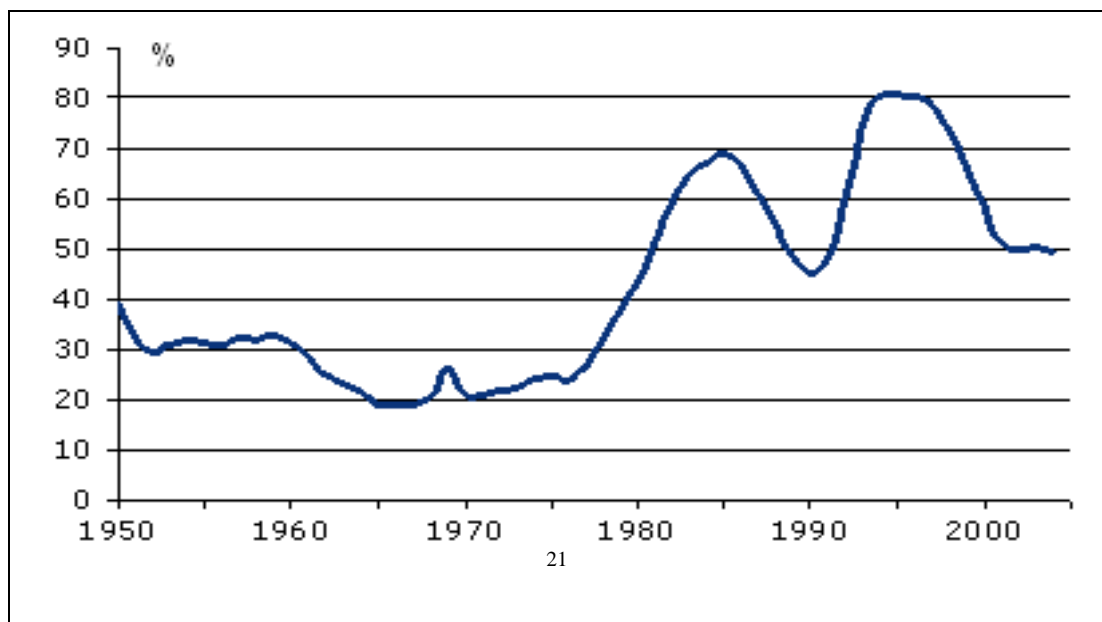
Sweden had a 0.3% budget surplus during the reference year 2003 according to the last convergence report. The average surplus during 2005 was 1.2%.^{17 18}

5. **The Government debt cannot exceed 60% of the GDP. If it does, then it should diminish sufficiently and approach the reference value (60%) at a satisfactory pace.**¹⁹

The debt has decreased since the latter part of the 1990's and was on average 50.3% during 2005; almost 10% lower than the reference value.²⁰

Figure 4

Government debt as share of GDP 1950-2004



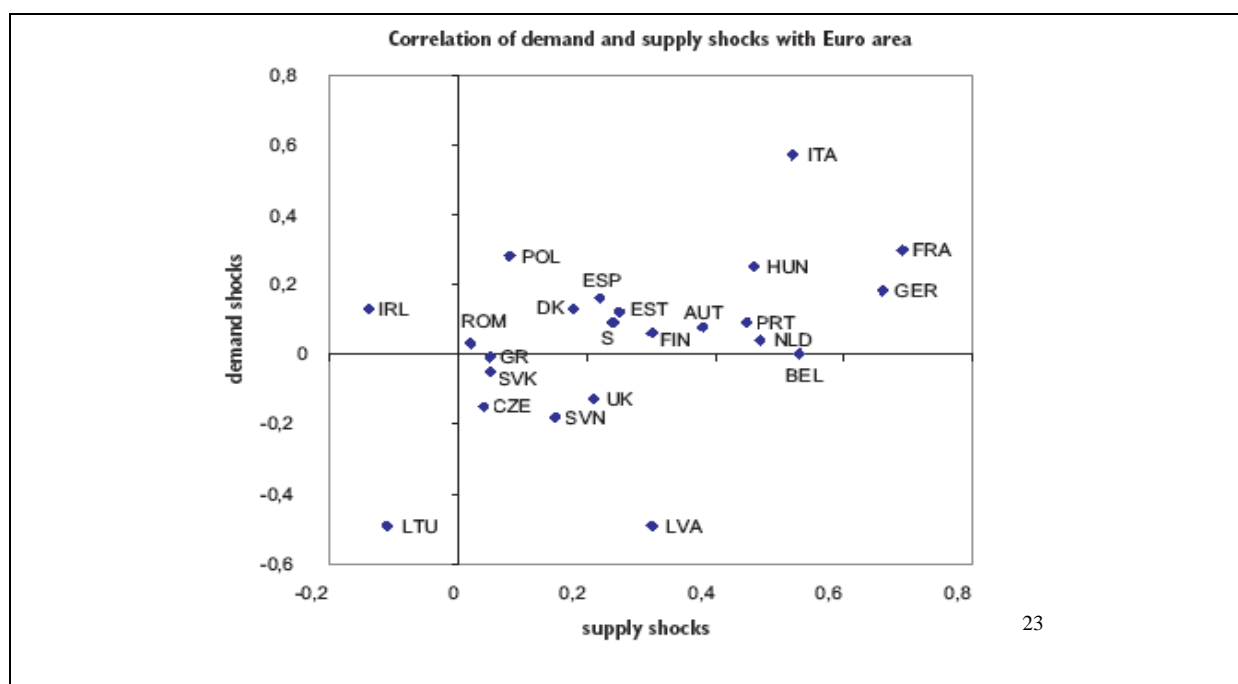
Would Sweden be good for the EMU?

Correlation of shocks

Shocks are to a certain degree correlated with the euro area average, but could be higher.

According to the European Commission, correlation will increase over time after adopting the euro. This makes it easier for the European Central Bank to use a monetary policy suited to all member countries. On the other hand side, according to Krugman (1991), correlation will decrease as countries specialize in certain areas of production, using the U.S. as an example.²²

Figure 5



Wage flexibility

Doctors in Economics, Stefan Carlen and Sören Wibe (1999), as well as Professor in international economics Lars Calmfors (1998) all agree that a reform in the labour market is needed before Sweden is ready to enter the EMU. According to Carlen and Wibe it is

practically impossible to decrease nominal wages and that there is no empirical evidence that this has happened in Sweden even during severe crisis in the past. It is possible to make wages grow at a slower pace. The problem is that the wages in Sweden are determined by contracts that last for years and it would therefore be a very slow process to change them. During the crises in the early 1992 when the central bank spent enormous amounts to defend the value of the Swedish krona and finally had to give it up, it depreciated straight away by 20%. Within twenty-four hours Swedish products were again competitive in the market. This would currently probably take years if it would be done by changing wages.²⁴

Labour mobility

The labour mobility is very limited. One reason is the language barrier. Another is a very generous Swedish social security system. Most people would probably rather live on grants than try to get a job in another country.²⁵ On the other hand, Sweden is one of only three countries that have not imposed restriction on labour coming from the 10 countries that became members of the EU on the 1st of May 2004. The thirteen other countries fear that migrants might “steal” jobs without restrictions. In this sense Sweden would be good for future EMU labour mobility.²⁶

Trade

Sweden is not a closed, but neither a fully open economy.²⁷ The majority share of Sweden's export is currently to countries outside the EMU. If Denmark and UK would enter the monetary union in the future, more than half of all export would be within EMU (under the assumption that the share of trade with the two countries remains the same).

Figure 6

Exports with current and future EMU countries, UK and Denmark, 2005 (% share of total export)	
	<u>Exports</u>
Current EMU countries 2005:	38.5%
Countries required seeking membership in the EMU 2005:	2.9%
UK and Denmark 2005:	14.4%

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Wage bargaining

Sweden's wage bargaining is centralized. The biggest labour union is LO with over 2 million members.²⁹ This should be a factor keeping inflation down as they realise that higher wages will lead to higher inflation.³⁰

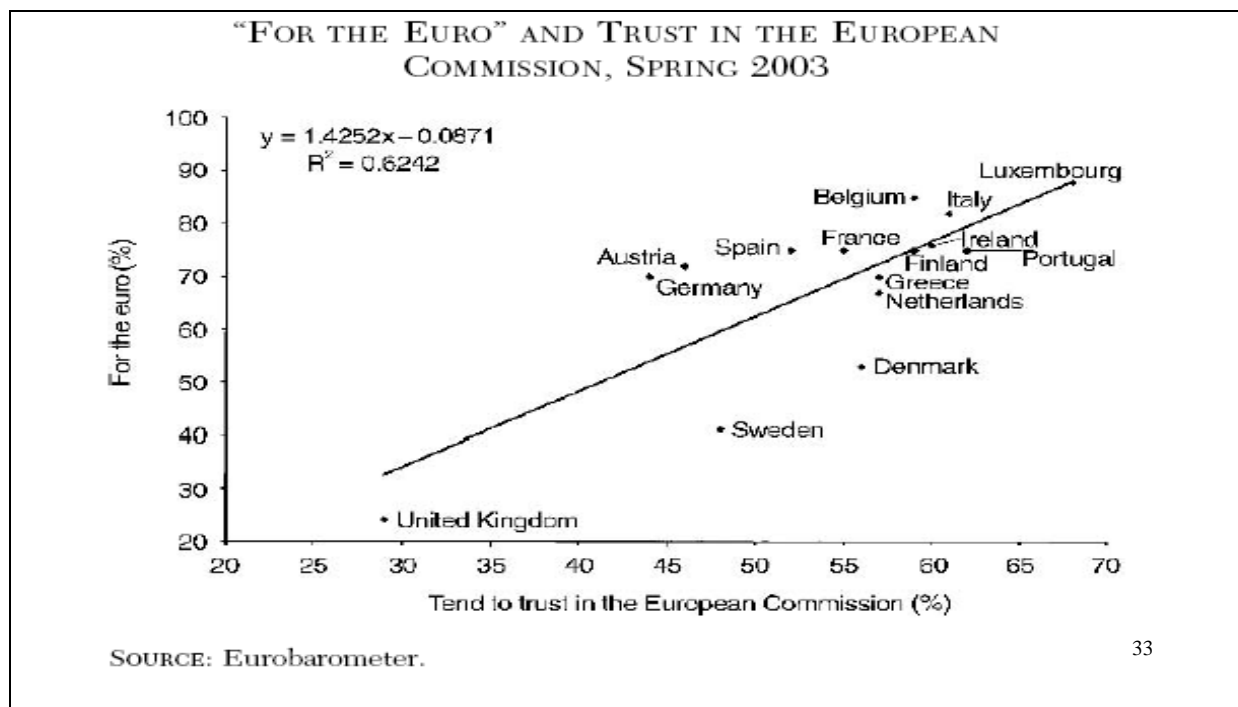
Diversifying

A Swedish entry into the EMU would help to diversify away the impact the countries with the biggest GDPs (e.g. Germany) has on the monetary union.³¹

Not trusting in the EC and the ECB fully

Lars Jonung's (2004) analysis of the Swedish referendum shows that many of the voters do not trust the European Commission and do not think the European Central Bank would act in the favour of Sweden. This could have an affect on the ECB's credibility. The attitude can of course change over time.³²

Figure 7



The main costs for Sweden when entering the EMU

Not controlling the monetary policy

The two main tools that can be used to affect the national economy in the short run, when permanent and temporary asymmetric shocks occur, are fiscal policy and monetary policy. If Sweden would enter the EMU they would have to give up the monetary policy as it would be controlled by the European Central Bank in Frankfurt. The result would be a “one-size-fits-

all” interest rate, which may be a problem when there is a divergence between economies within the EMU and would thus necessarily not always suit Sweden’s interests.³⁴

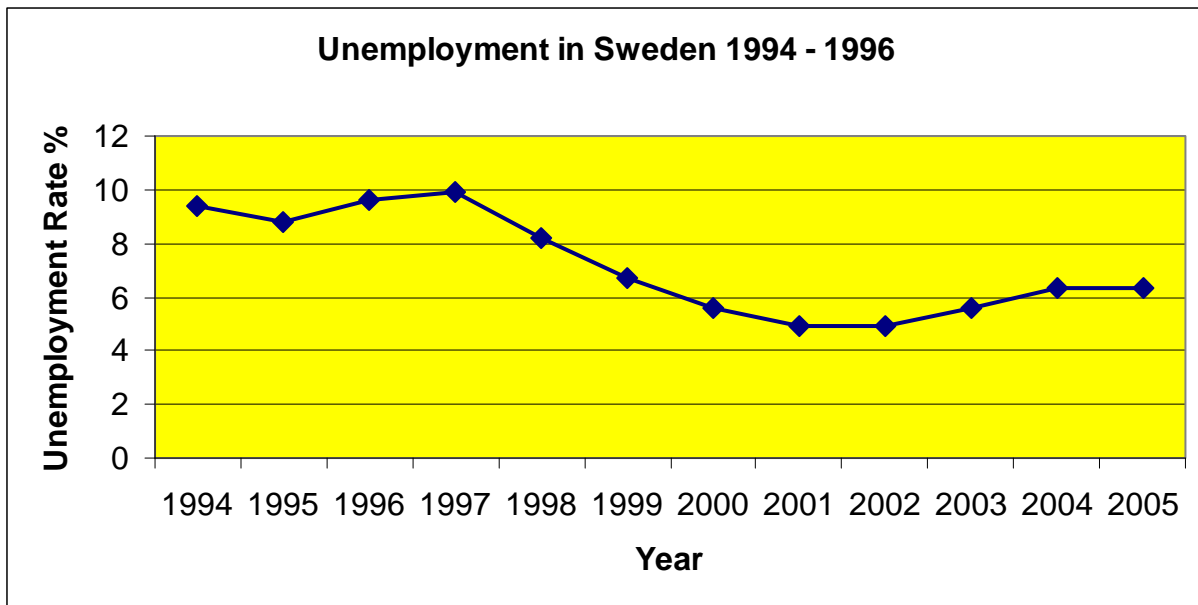
An example of a scenario that could occur:

Sweden’s growth is very slow. The government is planning to cut taxes to stimulate the economy. Suddenly a storm ruins an area of the country and the government has to increase its spending to sort out the damages. The budget deficit was already before the storm close to the 3% of GDP limit. A tax decrease can therefore not be used to stimulate the economy and monetary policy is no longer an option.³⁵

The risk of higher unemployment

The unemployment situation has been one of the most discussed topics in recent years in Sweden. It is being claimed that the unemployment rate would be higher if the high number of people who are on state make-work and training schemes would be included in it. The Calmfors report (1996) assessed whether Sweden would benefit from a membership in the monetary union or not (much like the Treasury’s five tests in the UK). One of the main reasons for coming to the conclusion that Sweden would benefit from waiting to enter was that the already high unemployment could increase, as the euro would not necessarily depreciate to make Swedish products more attractive. The unemployment rate was in 1996 9.6% and has since then declined, but is still thought to be higher than what the official statistics show.^{36 37}

Figure 8



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Price increase

During the period when the euro is introduced Sweden may experience higher prices, due to a collective price rise in the market. When for example a shop owner is setting new prices in euro on his products, the new price according to the exchange rate should be €3.34. He will then instead set the price at €3.50, since everyone else is doing the same.³⁹

The main benefits for Sweden when entering the EMU

Increased trade

Baldwin (2005), estimates that trade has increased by 5-15% for the current EMU countries since 1999.⁴⁰ One of the reasons is probably due to risk adverse people/companies having increased their trade as a result of the exchange rate certainty within the euro area.⁴¹

No transaction costs

The cost reductions due to no transaction costs are estimated by the European Commission to eventually be at the size of 0.25 - 0.5% of GDP, but will have a negative affect on the bank's revenues. Transaction fees are thought to be 5 % of the banking sectors revenue.⁴²

Increased competition

No transaction costs and the fact that it is easier to compare prices between countries should increase the competition. This may however only affect particular segments of the markets as some companies already are facing competition in their domestic country. Transport costs may be another problem for certain products.⁴³

Other disadvantages for Sweden staying outside the Eurozone

- Risking to forgo an economic boom in the euro area
- Lower level of political influence in the EU.⁴⁴

Conclusion

Sweden has currently no target date for adopting the euro.

The only area that Sweden is currently not fulfilling according to the Maastricht criteria is the exchange rate, due to the Swedish krona not yet joining the ERM II. According to the latest convergence report, the exchange rate of the krona has not been stable enough against the euro.

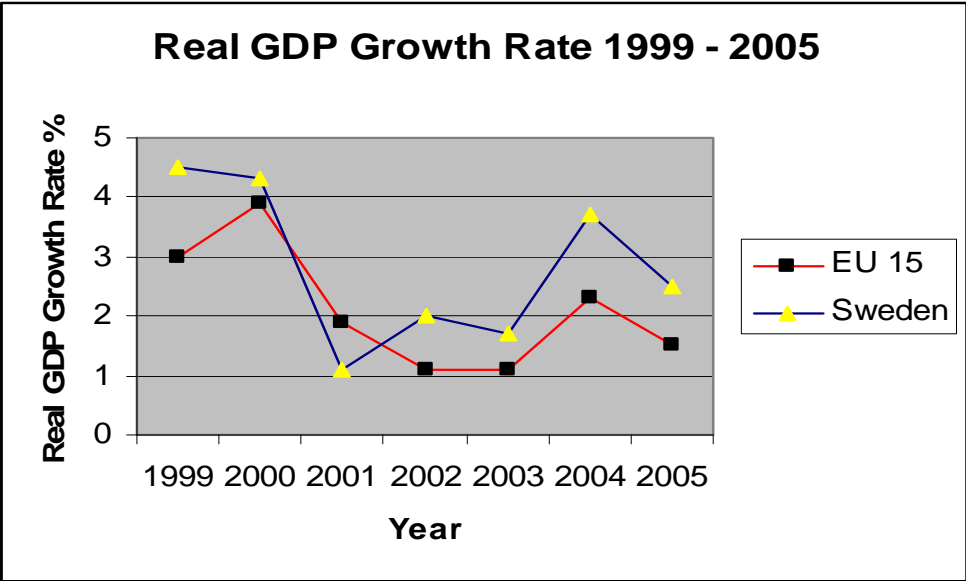
Wages and labour markets are currently not flexible enough to be seen as a good alternative to monetary policy when permanent asymmetric shocks occur. The correlation of shocks with the rest of the Eurozone may increase or decrease after joining the EMU. The trade with the current Eurozone could be higher. This is however likely to change after joining the EMU. Sweden is currently not an ideal candidate for the Euro zone.

The main advantage of staying outside the EMU would be the continuing control of monetary policy while the main advantage of joining the EMU would be increased trade with the Eurozone countries.

Figures 9-11 show that Sweden has had a higher growth rate, lower inflation and unemployment rate than the EU15 during a big part these first EMU years. Lars Jonung believes the Swedish euro negativity partly comes from Sweden, like Denmark and the UK, having been independent, stable democracies and successful nation states for unusually long periods of time.⁴⁵

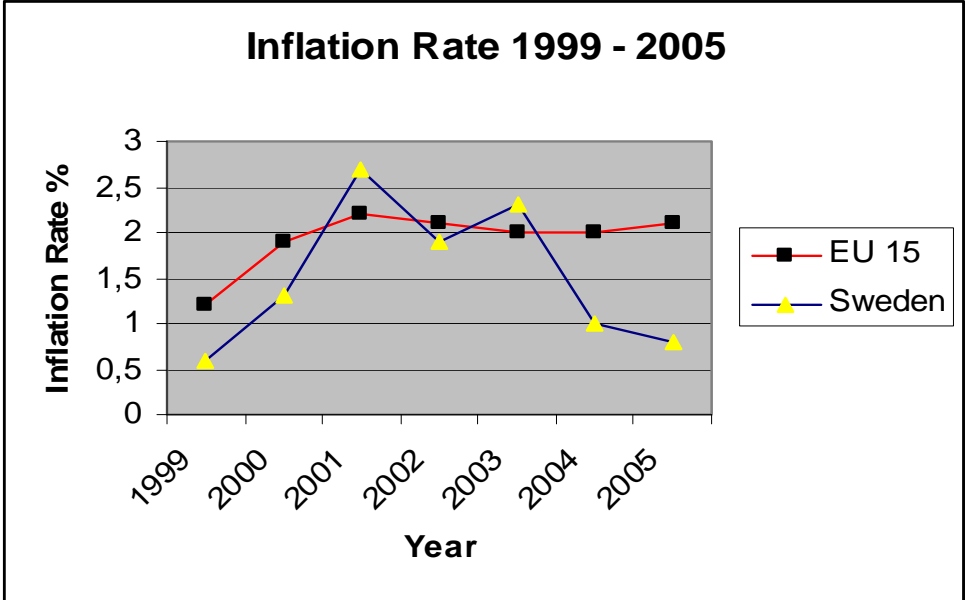
A struggling Swedish economy in a period when EMU is booming is what I think is needed for the majority in Sweden to vote for Sweden joining the EMU in a future referendum.

Figure 9



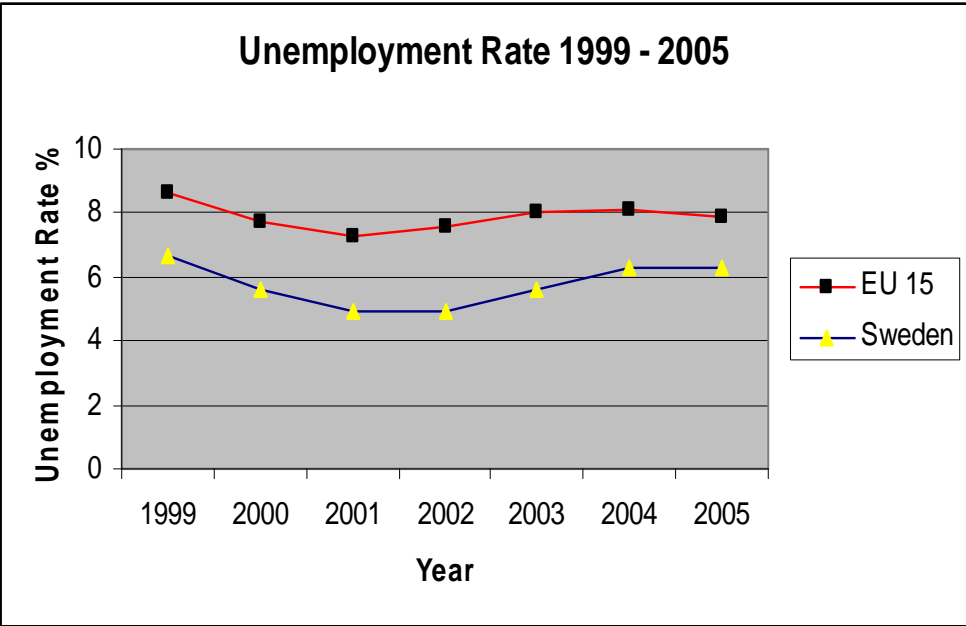
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Figure 10



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Figure 11



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