Government Bill 1997/98:25

on Sweden and Economic and Monetary Union

The Government submits this bill to the Riksdag.

Stockholm, October 2, 1997

Thage G Peterson

Erik Åsbrink
(Ministry of Finance)

Abstract of the Bill

The Bill discusses the issues associated with Sweden’s participation in Economic and Monetary Union (EMU). 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 monetary union. If the Government later finds that Sweden should participate, the issue will be placed before the Swedish people for judgement.

The Bill contains additional background information on EMU and a presentation of the conditions for Sweden outside monetary union. The Government describes Sweden’s preparations for the third stage by way of the convergence programme and the work on the practical preparations for the introduction of the euro.

Note: This is an informal translation of the authentic Swedish text and does not include the annexes of the Swedish text.

Contents

1 Proposal for a decision by the Riksdag

The Government proposes that the Riksdag

1. adopt as its opinion that Sweden should not introduce the single currency of the European Union, the euro, when the third stage of Economic and Monetary Union (EMU) is started,
2. approve the guidelines with respect to economic policy and EMU that the Government recommends (sections 6 and 7).

2 The Issue and Its Preparation

Ever since the issue of economic and monetary union (EMU) first came about in connection with Sweden’s negotiations for membership in the European Union (EU) Sweden has taken the position that the question of Swedish participation in the monetary union should be decided by Sveriges Riksdag, the Swedish Parliament. The Government is introducing in this Bill a proposal and a basis for the Riksdag’s decision on this issue.

In Government Bill 1994/95 on Sweden’s membership in the European Union there is a detailed account of Swedish negotiations on membership with reference to EMU and Sweden’s decision making process. There it is recalled, inter alia, that Sweden made a statement at the time the negotiations opened on February 1, 1993. It was repeated on November 9, 1993 and recorded in the minutes of the meeting. In the statement, which was reproduced as Appendix 1 to the Government Bill, it said, inter alia, ”A final Swedish position relating to the transition from the second stage to the third stage will be taken in the light of further developments and in accordance with the provisions in the Treaty”. The Cabinet Minister responsible informed the Riksdag on November 10, 1993 and said on that occasion, ”On the matter of the transition from the second to the third stage of EMU, it is ultimately the Riksdag that will decide the position”.

Sweden’s negotiating position on EMU was the subject of consultations between the then Government and Opposition. It was judged to be more appropriate to make a unilateral declaration than to try to get the same formal opt-out that Denmark and the United Kingdom have.

The Parliamentary Finance Committee (bet. 1994/95:FiU1y) declared that a final Swedish position on the transition from the second to the third stage should be made in the light of further developments and Sweden’s commitments as a Member State.

In the Government Bill on Sweden’s EU membership it was announced that there would be a special Government Bill on the matter of Sweden’s participation in the third stage of EMU when Sweden’s participation in the monetary union became an actuality. The Riksdag’s decision was in accordance with the Government’s proposal. In spring 1998 the Council in the composition of Heads of State or Government will select the participants in the first group of Member States that will introduce the euro when the third stage starts on January 1, 1999. Therefore the issue of Sweden’s participation in the monetary union is imminent and the Swedish position needs to be established in good time before this Council meeting.

The question of Sweden’s membership in the EU was the subject of a referendum on November 13, 1994. One of the preconditions for the referendum was that membership in the EU would not automatically lead to participation in the monetary union, and that a separate decision on EMU would be taken by the Riksdag. This was made clear in a governmental memorandum (Ds 1994:48), in which the results of the Swedish negotiations were described.

The overriding position of the Government in the matter of EMU has been to ensure the greatest possible freedom of action. Sweden shall have the possibility both to participate and not to participate. The most important in this context has been – and still is – the conduct of an economic policy that makes it possible for Sweden to meet the convergence criteria (applying to price stability, public finances, exchange rate stability and long-term interest rates). In addition practical preparations need to be carried out. However, these measures do not bind Sweden, but rather are designed in such a way as to leave open the alternatives of participation or non-participation to the largest extent possible.

In June 1995 Sweden presented a convergence programme. According to the programme, which a large majority in the Riksdag supported, the goal for economic policy, inter alia, is to fulfil the convergence criteria. In the programme it was also noted for other Member States, the Council, and the Commission that the question of Sweden’s participation in the monetary union will be decided by the Swedish Riksdag. This part of the programme did not give rise to any comments by the Council in its opinion on Sweden’s convergence programme which was adopted and made public in September 1995.

In October 1995 the Government decided on terms of reference for a commission which was given the task of analysing the consequences of a possible Swedish participation in stage three of economic and monetary union, the Government Commission on EMU as it was called. The Commission, chaired by Professor Lars Calmfors, submitted its principal report *EMU: A Swedish Perspective* (SOU 1996:158) on November 4, 1996. The report has been the subject of wide circulation for comment. The opinions have been published in a governmental memorandum (Ds 1997:22). In addition the Commission arranged for the production of 21 background reports.

In August 1996 the Government decided to establish a special function in the Ministry of Finance with the task of co-ordinating the practical preparations for the introduction of the euro. Five working groups were established to examine matters of legislation, public administration, the financial sector, business and issues of concern to citizens. A first report, *Practical Preparations for the Euro in Sweden* (Ds 1997:9) was presented in February 1997. A second report (Ds

1997:59), which also considered the issues that might be raised if Sweden remained outside the monetary union, was presented in September 1997.

The Government decided in August 1996 on terms of reference for an inquiry on responsibility for exchange rate policy issues. The special investigator Pierre Vinde presented his report *Responsibility for Exchange Rate Policy* (SOU 1997:10) in January, 1997. Among the special investigator's tasks was the proposal of constitutional and other legal changes required to give the Government responsibility for overall exchange rate policy decisions. The Government's reason for the inquiry was the changed conditions for exchange rate policy that were a consequence of membership in the EU.

In connection with party consultations in autumn 1996 it was decided that a working group with representatives from all the parties in the Riksdag would discuss constitutional and other legislative issues that had a bearing on the future status of the Riksbank. The result of the discussions was reported in the memorandum, *The Riksbank's Status* (Ds 1997:50). This work, as it applies to EMU, dealt mostly with issues arising from stage two, but certain questions that applied to the third stage (such as the issuance of banknotes) have also been considered. A Government Bill on these matters is expected to be presented to the Riksdag in November 1997.

The Minister of Finance announced in a public speech on June 3, 1997 that the Government in practice supported a recommendation on EMU from the National Board of the Social Democratic Party. It recommended taking the following position: given the Swedish peoples' weak support for EMU, Swedish participation in the monetary union is not to be considered when it starts on January 1, 1999. However Sweden should preserve its freedom of action in order to make a later Swedish entry possible. Membership should not be considered unless it is submitted to the Swedish people for consideration. It is still desirable that such a consideration is made in a general election but it cannot be ruled out that it will instead be made by an extra election or a referendum. The recommendation was approved at the Social Democratic Party Congress in September 1997.

Representatives of the Swedish Government had extensive consultations with colleagues in other Member States before the Government took its position in June and they were also informed afterwards.

Outline of the Government Bill

Accordingly the position of the Government on the overall question of Sweden's participation in the monetary union when it is started on January 1, 1999 is already established. This position forms the basis for this Government Bill.

Chapter 3 gives background information on EMU. Here there is an overview and a description of EMU from its beginnings until today.

One section describes the progress of Member States toward economic convergence.

Chapter 4 enumerates the terms for Sweden outside the monetary union with emphasis on legal and institutional conditions. Even if Sweden does not introduce the euro, stage three will signify changes in the existing situation.

Chapter 5 discusses Sweden’s preparations for stage three with respect to the economy and practical measures.

Chapter 6 contains the views of the Government on Sweden’s economic policy outside the monetary union.

Chapter 7 contains the Government’s views on the questions of Sweden’s participation in the monetary union from the start and the conditions for a possible future entry.

3 Background

3.1 An Overview of EMU

3.1.1 The Transition to Stage Three

Stage three of EMU will begin on January 1, 1999. Those Member States of the EU with economies which are deemed to have achieved a sufficient degree of sustainable economic convergence and which satisfy the other conditions for entry that have been established will then form a monetary union. From the first day of stage three, the exchange rates of the participating countries will be irrevocably fixed and the single currency – the euro – will be introduced at the same time that a common monetary and exchange rate policy for participating countries will come into effect. From the first day of stage three, the euro will be an official currency. The monetary and exchange rate policy operations of the European Central Bank (ECB) will be in euros. The euro will be possible to use for different sorts of payments and transfers in the financial system, but notes and coins will first be introduced at a later stage. During an initial period, which could last up to three and a half years, national notes and coins will continue to be used as legal tender in participating countries. Euro notes and coins will be introduced January 1, 2002 at the latest.

According to the EC Treaty, a monetary union will be formed among the Member States that fulfil ”the necessary conditions” for the adoption of a single currency. Central to the assessment are the convergence criteria that are laid down in the Treaty and in the Protocol annexed to it. The criteria are, in brief:

- The achievement of a high degree of price stability. The rate of inflation should not exceed by more than 1,5 percentage points that of, at most, the three best performing Member States in terms of price stability.

- A sustainable government financial position. A Member State must not have a government budgetary position with a deficit that is excessive according to the so called excessive deficit procedure. The reference values specified are, for the deficit, 3 per cent of GDP and, for the gross debt, 60 per cent of GDP.
- The observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System for at least two years without having devalued on its own initiative against the currency of any other Member State.
- The long-term interest rate may not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability.

A further prerequisite for participation in the monetary union is that the national central banks of the Member States have an independent status in accordance with the provisions of the Treaty.

The Member States which will be included in the first group of participants in the monetary union are to be designated in the spring of 1998. On the basis of reports from the Commission and the European Monetary Institute (EMI), the ECOFIN Council (that is, the Council in the composition of Economics and Finance Ministers) will decide which Member States fulfil the conditions for participation. On the basis of a recommendation from the ECOFIN Council, the Heads of State or of Government – assembled within the framework of the provisions for the Council – will make the final decision.

Those Member States which, at the time of the spring 1998 selection, are deemed by the Heads of State and Government to fulfil the necessary conditions have both the right and the obligation to participate in the monetary union. Those Member States that do not qualify for participation in the monetary union will have so called derogation status. When the Maastricht Treaty was negotiated, United Kingdom and Denmark agreed special Protocols that gave them the right not to participate in the monetary union.

3.1.2 The Single Monetary Policy

The responsibility for the monetary policy of participating Member States will be transferred from the start of the monetary union to the European System of Central Banks (ESCB), which will be composed of the national central banks and a common central bank, the European Central Bank (ECB).

The ESCB shall define and implement monetary policy within the union. The ECB will have the exclusive right to authorise the issue of bank notes within the monetary union and will be given the power to use prevailing monetary policy instruments – for example, the right to carry out open market operations and establish requirements for minimum reserves.

The primary objective of the ECB will be to maintain price stability. Without prejudice to this objective, the ESCB will support the general economic policies within the Community and contribute to the achievement of the objectives of the Community as laid down in Article 2 of the EC Treaty – inter alia, a sustainable, non-inflationary growth and a high level employment.

The Treaty gives the ESCB a clearly independent status, above all by means of the instruction prohibition. This means that neither the ECB nor the national central banks will be allowed to seek or take instructions from governments of Member States or from any Community body. Another provision is that national governments and Community bodies will not seek to influence the ECB.

The ESCB shall be governed by the decision-making bodies of the ECB. The highest decision-making body, the Governing Council of the ECB, will comprise the Governors of the national central banks of those Member States which participate in the monetary union and the members of the Executive Board of the ECB. The Executive Board shall consist of four to six members and have ongoing day-to-day responsibility for the single monetary policy.

The Governors of the central banks in Member States that remain outside the monetary union will be included in the General Council, which, inter alia, will function as a forum for contacts among all central banks in the ESCB.

While the ECB has been assigned strict and entire responsibility for monetary policy, important decisions on exchange rate policy are the responsibility of the ECOFIN Council. The Council has the power to enter into formal agreements on the exchange rate system with third countries or alternatively, to issue general orientations for exchange rate policy in relation to one or more currencies in third countries. However the Treaty gives the ECB a substantial role in the decision-making process before the Council decides exchange rate matters. One important reason for this is to minimise the risk of a conflict between exchange rate policy and the price stability objective of the ESCB.

3.1.3 Economic Policy

No transfer of competence over general economic policy, with the exception of monetary policy, will be made in stage three. However, it will be incumbent on all Member States to regard economic policy as a matter of common concern and to strive to co-ordinate economic policy. Member States shall also respect the rules that are made to secure budget discipline.

Co-ordination of economic policy by Member States was mentioned already in the Treaty of Rome. The concrete plans to establish an economic and monetary union have reinforced the goal of economic policy co-ordination among Member States. In line with this goal, surveillance and co-ordination procedures were introduced in that part of the Treaty of Maastricht pertaining to EMU.

Rules on multilateral surveillance were introduced in the Treaty. Within the regulatory framework for multilateral surveillance, non-binding broad guidelines for the economic policy of Member States and the Community are drawn up. These broad guidelines are formulated once a year and adopted at the highest political level by the European Council.

The Council shall, on the basis of reports from the Commission, monitor the economic policies of Member States to see that they are in accordance with the broad guidelines. The Council may make recommendations to Member States which have economic policies which are not consistent with these guidelines.

Great importance has been attached to the goals of price stability and sound public finances in the formulation of regulations on economic and monetary union. Ever since stage two began, so called monetary financing – government borrowing direct from the central bank – has been prohibited. Further, special treatment favouring government bodies at financial institutions is not allowed. The rules are aimed at ensuring that general government borrowing for deficit financing will be based on market-related conditions. A third rule forbids the Community and Member States from assuming responsibility for any other Member State's public debt.

The regulatory framework aimed at securing fiscal policy discipline was strengthened by the approval of the Stability and Growth Pact in the summer of 1997. The Stability and Growth Pact consists of two Council Regulations and a Resolution from the European Council.

Under the pact, Member States agree to keep general government finances close to balance or in surplus over the medium term. The medium-term budget goals that are stated in the Pact should be incorporated into the stability programs for those Member States participating in the monetary union and into the convergence programs for those remaining outside. An early warning system is established so countries can be alerted if there are indications that they may exceed the reference value of 3 per cent of GDP for the deficit. The early warnings are presented in the form of non-binding Council recommendations to Member States. With respect to the excessive deficit procedure, time limits for the different steps in the process are introduced. It is also clarified in what situations sanctions will be used and rules for calculating fines and deposits are established.

The Stability and Growth Pact applies to all Member States, with important restrictions on Member States that do not participate in the monetary union.

3.2 The EMU Process

3.2.1 Historical Overview

A monetary union represents far-reaching co-operation. EMU, therefore, is a particularly important step in the process of European integration. Independent states are prepared to give up their right to make decisions on monetary and exchange rate policy at the national level. There have long been plans within the Community for an economic and monetary union. However only in the past decade have they become quite concrete and a priority. The driving forces have been both political and economic.

When the Treaty of Rome was signed in the 1950s, the Bretton Woods system of fixed exchange rates was in effect. This system ensured a high degree of exchange rate stability between Member States, including those of the European Community (EC). Therefore, there was no need of special exchange rate co-operation within the framework of the Community.

At the EC's summit meeting in The Hague in 1969, it was decided to examine the possibilities of establishing an economic and monetary union for the Community. Underlying this decision was the increasing economic integration between Member States and the symptoms of instability in the Bretton Woods system. A working group presented the so called Werner Plan in 1971, which led to a resolution to establish an economic and monetary union in two stages by 1980. The Werner Plan was never implemented. A factor, which impeded realisation of the plan, was the turbulence in connection with the collapse of the Bretton Woods system.

At the meeting of the European Council in Paris in 1972, the goal of an economic and monetary union was reaffirmed. This was followed the same year by the establishment of what became known as the *currency snake*. Several European countries, even countries outside the Community, co-operated in this exchange rate system. Sweden participated in the currency snake during the period 1973 – 1977.

In 1978 the European Council decided to establish the European Monetary System (EMS). In doing so, the ambitions were significantly raised for monetary co-operation in the EC. The most important feature of the EMS is the Exchange Rate Mechanism (ERM). Under this system bilateral exchange rates were established between all the participating currencies. A band for the greatest permissible fluctuations in the exchange rates was set around the central exchange rates. The normal fluctuation bands were plus/minus 2.25 percent. The Member States that had currencies that were not part of the currency snake were given fluctuation bands of plus/minus 6 per cent. At the fluctuation margins, an obligatory and, in principle, unlimited obligation to intervene came into effect. The central rates could be realigned, for example, when a participating Member State had experienced a very large deviation in prices and costs. An important component of the system was that adjustments in the central rates were decided jointly, rather than unilaterally by the country in question.

During the first years of ERM the central rates were adjusted a number of times. During this period the economic policies of some Member States were not sufficiently geared to stability. At the beginning of the 1980s many countries introduced a stability-oriented economic policy and the adjustments to the central rates became fewer. From 1987 to 1992 no adjustments were made to the central rates. In part this reflected a higher degree of economic convergence. Another explanation was a strong political disinclination by several Member States to make adjustments in these rates in spite of the fact that price and wage developments justified them.

At the end of the 1980s, the EC achieved notable success, with the implementation of the single market, favourable economic growth and a strong belief in the future. Plans for an economic and monetary union were revived. At a summit meeting in Hanover in 1988, a working group composed of the Governors of central banks and a few outside experts under the leadership of Mr Delors, then president of the Commission, was assigned the task of working out a plan for economic and monetary union. The group presented its report in 1989 - the so called *Delors Report*. According to this report EMU should be realised in three stages.

The report made it obvious that a change in the Treaty would be necessary. At the meeting of the European Council in Strasbourg in 1989 it was decided to convene an Intergovernmental Conference on EMU.

After intensive and far-reaching negotiations, a new treaty was agreed in the Dutch city of Maastricht in December, 1991 and was signed on February 7, 1992. The ratification process was difficult and drawn out and it could not be completed before autumn 1993. The new treaty came into effect on November 1, 1993.

A serious crisis in the EMU process prevailed during the years 1992 to 1993. The stability hitherto experienced with the ERM had generally given the impression that the formation of the monetary union would be quite without problems. Owing to considerable unrest in the foreign exchange markets, the British pound and the Italian lira were forced to leave the ERM. In addition several adjustments in the central rates were made. In the summer of 1993 the ERM’s existence was seriously threatened and plans for EMU appeared uncertain. On August 1, 1993, ministers and Governors of the central banks decided to widen the bands in the ERM to plus/minus 15 per cent. These fluctuation bands still apply. The stability of the ERM has increased significantly after this decision. The market rates for the currencies of the majority of participants have remained relatively close to the central rates, even if the fluctuations in many cases have been bigger than the earlier narrow bands of plus/minus 2.25 per cent.

The Austrian shilling joined the ERM in 1995, a short time after Austria became a member of the EU. In autumn 1996 the Italian lira rejoined the ERM and the Finnish mark joined the mechanism.

3.2.2 Stage One of EMU

Stage one of EMU was introduced on July 1, 1990, that is, even before the Maastricht Treaty had come into force. The main feature of this stage was a certain degree of increased co-ordination of economic policy. Economic policy became the subject of more frequent discussions among ministers and senior civil servants, based on, inter alia, the so called convergence programmes, which were submitted on the responsibility of each Member State when needed. Monetary policy was co-ordinated through the Committee of Governors of the Central Banks. At the time of the introduction of the first stage, the movement of capital between Member States was, with certain exceptions, to be freed from restrictions.

3.2.3 Stage Two of EMU

The second stage was introduced on January 1, 1994 and will continue until the third stage starts on January 1, 1999. Accordingly, when Sweden became a member of the EU on January 1, 1995, Stage two was in progress.

Most of the rules or regulations on economic policy came into force at the start of the second stage. Among them are the restrictions on financing the public sector deficit (Article 104-104b).

The excessive deficit procedure began to be applied at the beginning of Stage two, but the strongest pressures under this procedure will first be brought to bear on participating Member States in Stage three. The weak public finances in the EU have led the Council to decide that a large majority of Member States have excessive deficits. Only Ireland and Luxembourg have never been the subject of such a decision.

Some strengthening of the economic policy co-ordination mechanisms has taken place. The broad guidelines for economic policy are established annually. These guidelines have been followed up regularly and the ECOFIN Council and the European Council routinely discuss the economic situation with special emphasis on progress towards achieving convergence. Member States have, on their own responsibility, continued to prepare convergence programmes, which are the subject of Council discussions.

Member States retain full competence over monetary policy for the entire second stage. However co-operation in this area is being intensified. At the start of the second stage, the *European Monetary Institute (EMI)* was established. The EMI will make a number of operational and practical preparations for the third stage and it will strengthen the co-ordination of monetary policy. The EMI is governed by a Council consisting of a President and the Governors of the national central banks of the Member States. The EMI has, in accordance with the EC Treaty, reported annually on the status of the preparations for the third stage. The activities of the EMI are largely concentrated on the preparation of a single monetary policy. The EMI also follows progress towards convergence and issues independent assessments on this subject. In addition the EMI contributes to the work of the Council on several issues, for example, exchange rate co-operation and legislation on the ECB.

During the second stage every Member State must make the changes in national legislation required to make its central bank independent. By the time that the ESCB is established, at the latest, national legislation, including legislation with respect to the central bank, should be compatible with the EC Treaty. The United Kingdom is exempted from this obligation if it decides not to participate in the monetary union.

In spring 1995 the Commission presented the so called Green Paper on the transition to a single currency. The Green Paper contained proposals on the practical arrangements for the transition. These arrangements are only specified in part in the EC Treaty. The Green Paper was followed by extensive work in the Council, the Commission and the EMI, with the result that the European Council meeting in Madrid in December 1995 was able to agree on a change-over scenario. At that time it was also decided that the single currency would be called the euro.

The Maastricht Treaty does not regulate the relation between the euro and the currencies of the Member States that will not participate in the monetary union. In Madrid it was decided to begin work on this question. This led to an agreement on a new exchange rate mechanism – ERM 2 – which will replace the current ERM at the beginning of stage three.

In November 1995 Germany presented a proposal for a Stability Pact. The aim of the proposal was to secure budgetary discipline in stage three. After long and sometimes difficult negotiations, an agreement in principle was reached at the summit meeting in Dublin in December 1996 and the completed Pact could finally be adopted in connection with the summit meeting in Amsterdam in summer 1997. With this agreement one of the most difficult political issues before the monetary union was resolved.

In Dublin there was also an agreement in principle on two Council Regulations on the legal status of the euro. These Regulations, which were made public in the summer of 1997, are important in order to establish legal certainty among economic agents with respect to, inter alia, contract continuity and the relation between the euro on one side and the national currency unit and the ecu on the other.

The difficulties that Member States have had in reaching a sufficient degree of convergence have made the EMU process uncertain on several occasions. It is primarily the public finances that diverge excessively from the requirements of the Treaty. In 1995 twelve Member States had excessive budget deficits and in 1996, there were eleven. According to the procedures in the EC Treaty, stage 3 could have been started had there been a decision in 1996. A first assessment had to be made. It was purely *pro* forma, since it had been obvious for a long time that the necessary majority of Member States which had fulfilled the conditions for entry would not exist.

During 1997 the discussions on other matters that have an important impact on how economic policy is to be conducted in the monetary union have continued. They have been related to the external aspects of the euro, inter alia, the role of the Council in exchange rate policy. Another question has been the extent to which Member States should co-ordinate their economic policy and how this should be done.

3.2.4 The Process during 1998

Important decisions on EMU will be taken during 1998. There is a relatively concrete and precise schedule:

- Before the first of March, Member States will report public finance data to the Commission in accordance with the rules on the excessive deficit procedure.
- Thereafter the Commission and the EMI, in accordance with Article 109j(1) in the EC Treaty, will issue reports on how Member States fulfil their obligations aimed at bringing about EMU. The reports will assess whether Member States have achieved a high degree of sustainable convergence. This will be done by an analysis of to what extent the convergence criteria have been fulfilled. The reports will also contain a review of the legislation on each Member State's central bank.
- The European Parliament will be consulted.
- The ECOFIN Council, acting by a qualified majority, will decide in the form of a recommendation whether each individual Member State fulfils the necessary conditions for introducing the euro. The assessment will be made on the basis of actual results for 1997.
- At the end of April or the beginning of May, the Council, meeting in the composition of Heads of State or of Government, acting by a qualified majority, will decide which Member States fulfil the necessary conditions. In connection with this decision, the conversion rates between the currencies of the participating Member States will be announced.
- As soon as possible thereafter, the Executive Board of the ECB will be appointed by mutual agreement among the participating Member States. Prior to this, the European Council and the Council of the EMI will be consulted. Once the executive board of the ECB is appointed, the ECB and the ESCB are established.

The ESCB will have about six months to finalise preparations for the monetary union. On January 1, 1999 the monetary union will be established. The ECB will assume responsibility for monetary policy from the participating Member States.

3.3 The Convergence Process in the EU

3.3.1 Introduction

In order for the monetary union to function well, Member States are required to pursue a long-term, stability oriented economic policy with sound public finances and stable prices as the core.

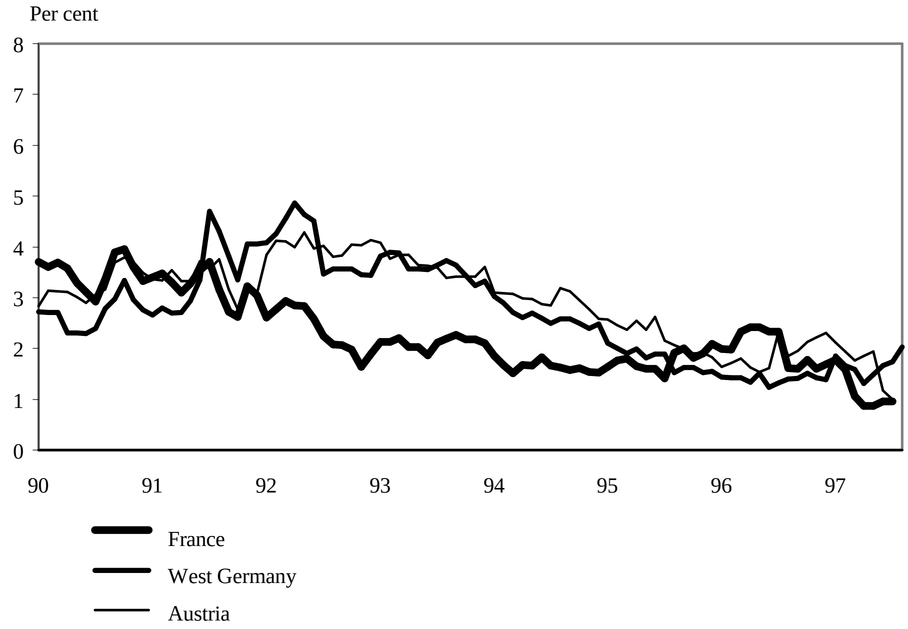
The process towards convergence means diminishing economic differences vis-à-vis those countries which have the most stable long-term economic development. Only those countries that have achieved a high degree of sustainable convergence will be allowed to participate in the monetary union.

The forecasts on public finances are from the OECD. Developments in Sweden are considered in more detail in section 5.1.

3.3.2 Price Stability

Inflation has gradually fallen in EU countries as a group since the end of the 1970s. For a long time the differences in inflation among various countries were significant. Some countries – among them Germany, the Netherlands, Belgium and Austria – at an early stage implemented a policy aiming at low inflation (see diagram 3.1), while others – among them Italy, Spain and Portugal – experienced a long period of high inflation (see diagram 3.2).

Diagram 3.1 Inflation in France, Austria and Germany



Sources: OECD and the Ministry of Finance

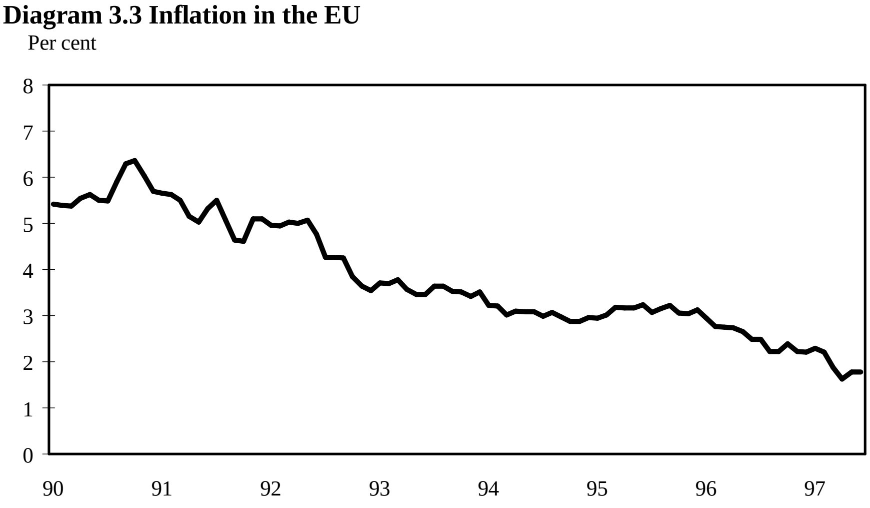
Diagram 3.2 Inflation in Spain, Italy and Germany

Sources: OECD and the Minisry of Finance

Since the beginning of the 1990s, the rate of inflation has fallen in all Member States, most of all in those countries which previously had had the highest inflation, Spain and Italy among them. At the same time the differences in the rate of inflation among EU countries has declined sharply.

According to the national consumer price indices, inflation in the EU as a whole fell to 2.6 per cent on average in 1996, compared with 3.1 per cent in 1995 (see diagram 3.3).

Diagram 3.3 Inflation in the EU



Sources: OECD and the Ministry of Finance

Inflation has continued to fall between 1996 and 1997 and currently stands at historically low levels. In step with this continued decline in inflation, the differences among countries with respect to the rate of inflation have also shrunk further. At the end of September 1997 all countries except Greece had an inflation rate under or near 2 per cent, according to the Harmonised Consumer Price Index (HCPI).

An important factor behind the move towards lower and lower inflation in the EU area is the great importance that many countries have attached to low inflation to create the conditions for sustainable economic growth. Budget consolidation appears also to have contributed to lower inflation as have the weak economic conditions. In some cases participation in the ERM may also have contributed to low inflationary expectations and thereby to low inflation because the exchange rate has functioned as an anchor to monetary policy.

No significant increases in inflationary pressures in the EU are foreseen in the coming year. Low inflationary expectations and considerable excess capacity in most countries are contributing to this outlook.

3.3.3 Public Finances

At the beginning of the 1990s, public finances in most EU countries were characterised by large deficits. Since the 1970s there has been a trend to gradually increasing public indebtedness in nearly all Member States. The situation worsened further during the recession in 1992 to 1993. The deficit in the fiscal balance as a share of GDP for the EU as a whole reached a peak in 1993 when it amounted to more than 6 per cent of GDP.

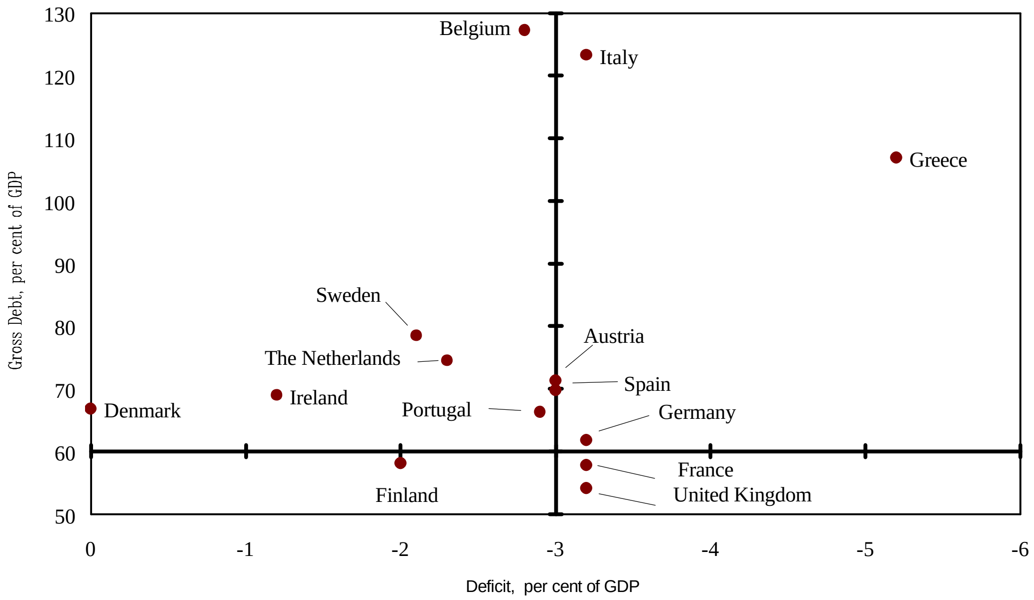
The problems and risks associated with ever increasing imbalances in the public finances – especially increased inflation, higher interest rates and lower growth – seem to have contributed to the consolidation process which most countries are now undertaking. Another contributing factor is the ambition of Member States to fulfil the convergence criteria for public sector finances in 1997.

Despite the recession that took place at the end of 1995 and during 1996, the budget deficit in the EU as a whole has decreased as a share of GDP. The average deficit declined from about 5 per cent of GDP in 1995 to barely 4.5 per cent in 1996. In the past years a few countries – Sweden, Finland, Italy and Spain among them – have been able to show an especially large reduction in their budget deficits.

Trends in Germany have been less favourable, even if it began with a stronger position. Having had a deficit of 2.4 per cent of GDP in 1994, Germany was the only country in which the deficit increased between 1995 and 1996. In 1996 the deficit amounted to 3.4 per cent of GDP. This increase can be partly explained by the effects of the German reunification. France has brought down its deficit from 5.6 per cent in 1994 to 4.2 per cent of GDP in 1996.

Fiscal policy in EU countries has continued to be tight during 1997 and budget deficits are estimated to decline further. According to the Commission and the OECD, as well as the IMF, the majority of EU countries will achieve, or nearly achieve, the reference value of 3 per cent of GDP in 1997. According to the OECD Sweden is expected to have a deficit of 2.1 per cent of GDP in 1997.

Diagram 3.4 Forecast for the public sector´s deficit and debt 1997 in the EU countries



Note: Luxembourg is expected to have a budget surplus of between 1 and 2 per cent in 1997. According to the OECD the debt ratio amounted to 6.4 per cent of GDP in 1996.
Sources: OECD, Economic Outlook, June 1997

In order for the monetary union to function well, public finances must be sustainable; sustainable public finances mean, inter alia, that the improvement must be lasting in nature. Though some of the measures have been of the ”creative accounting” sort, the non-cyclical component of the deficits, that is, that part of the changes in public finances which is not dependent on cyclical trends, decreased this past year. According to the OECD, among others, the budget deficit in the majority of EU countries is also expected to continue to decline during 1998. However if no further measures are taken, the deficits in Italy and Austria will increase during 1998.

The public sector gross debt continued to increase until 1996 despite the decrease in the budget deficits. Only Luxembourg, France, United Kingdom and Finland are expected to have a debt ratio under 60 per cent of GDP in 1997. However between 1996 and 1997 the majority of Member States are expected to be able to show a decrease in the debt ratio as a share of GDP, owing to the tightening of fiscal policy and favourable interest rate developments. In some cases the lower debt ratio can also be explained by privatisation and other transactions that do not affect the general government balance. However according to the OECD, Germany and Austria will have a rising debt ratio if no additional measures are taken.

3.3.4 Exchange Rate Stability

The exchange rate mechanism ERM has been the core component of co-operation among EU countries to establish stable exchange rates. This co-operation has, as mentioned earlier, occasionally been put to the test, not least during the currency speculations in 1992 and 1993. In spring 1995 the Portuguese escudo and the Spanish peseta were devalued.

After 1995 exchange rate developments in the ERM have been more stable and no further adjustments in the central rates have been made. The Italian lira, which depreciated sharply after Italy left the ERM, has gradually strengthened since the latter part of 1995 and rejoined the ERM in autumn 1996. The Finnish mark became part of the ERM about the same time, so that now all EU countries except United Kingdom, Sweden and Greece participate in the exchange rate mechanism ERM.

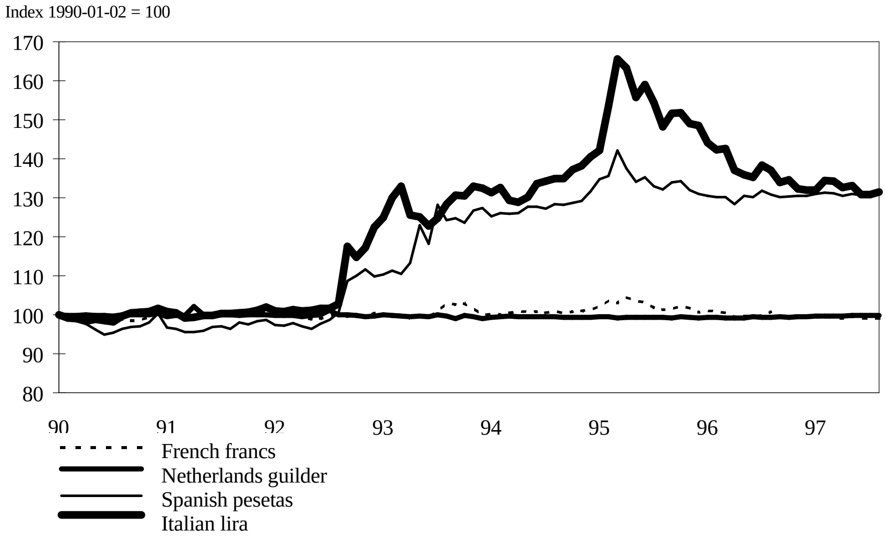
Swings in the bilateral exchange rates in the ERM have in general been moderate during 1996 and 1997. With the exception of the Irish pound, the divergence from the bilateral central rates has kept well within the stipulated fluctuation bands of plus/minus 15 per cent. Some currencies have been very stable: primarily the Austrian shilling, the Dutch guilder, and the Belgian franc, which have all had only very small variations in relation to the German mark. Some currencies have occasionally moved outside the old band widths, for example, the French franc and the Finnish mark.

As a consequence of very strong economic growth and its tendency to follow the British pound closely, the Irish pound has strengthened sharply in the ERM and the currency’s divergence against the central rate of the weakest currency has increased to between 10 and 12 per cent.

Outside the ERM, the British pound depreciated after it left the mechanism in 1992. The pound has later appreciated sharply and has almost reached the same level against the German mark that it had when United Kingdom left the ERM. The strengthening of the pound should be seen in the light of stronger economic growth in United Kingdom, compared with continental Europe. The strong growth has caused a gradual increase in the short-term rates. Inflation has remained low. The Swedish krona depreciated substantially after 1992 and reached its weakest position in April 1995 with a bilateral exchange rate of 5.5 kronor per German mark. Thereafter the krona has tended to strengthen and at the end of September 1997 the exchange rate is about 4.3 kronor to the German mark.

All in all the picture that emerges is one of relatively stable exchange rate developments during 1996 and 1997 in comparison with the beginning of the 1990s (see diagram 3.5). The movements in the exchange rates in the ERM have generally diminished. The strongest exchange rate movements have applied to currencies of appreciating tendencies – the Irish pound in the ERM and the British pound outside. No currency has shown any marked weakness or has been subject to pressure on the foreign exchange markets during this period.

Diagram 3.5 ExchangeRate Developments in Selected Countries compared with the German Mark



Sources: Hansson & Partner AB, Ministry of Finance

An ever-greater degree of price stability and reduced differences in the rate of inflation among EU countries seem to have contributed to this development, as has more credibility in the budget consolidation efforts in individual countries. Another significant factor is that the political commitment to the EMU process has increased the financial markets' expectations that the monetary union will start according to schedule. This has contributed to especially favourable developments with respect to those currencies that were earlier characterised by the most instability, for example, the Italian lira (see diagram 3.5). An additional reason for the calmer exchange rate situation may be the widening of the fluctuation bands in the ERM, which were introduced in 1993.

3.3.5 Long-Term Interest Rates

The long-term interest rates were high at the beginning of the 1990s and the differences between countries were significant. The ten-year rate in Germany, which had the lowest rate, was about 9 percent, while the Italian and Spanish rates were 13 to 14 per cent.

The long-term rates thereafter have followed a downward trend in all EU countries. However from 1994 to 1995 the rates in EU countries rose, inter alia, as a consequence of rising interest rates in the United States. Since then a clear decline in interest rates has taken place. On average the long-term rate in EU countries fell by more than one percentage point between 1995 and 1996. At the same time the differentials between the countries long-term interest rate levels have shrunk significantly. For example the differential between the Spanish and the German long-term rates declined from nearly 6 percentage points in 1990 to about 2.5 percentage points in 1996.

The differences in interest rate levels between EU countries have also shrunk further (see diagram 3.6) during 1996 and 1997. For example the differential between the Italian and German long-term rates at the end of September 1997 amounted to about 0.7 percentage points, while during 1996 the differential was nearly 3.5 percentage points. The differential between the Spanish and Portuguese long-term rates and the German long-term rates at the end of September 1997 was even smaller.

The Swedish long-term rates have followed a downward trend since autumn 1995 and at the end of September 1997 the differential between Swedish and German long-term rates was around 0.6 percentage points.

Diagram 3.6 Long-term Interest Rates in Selected Countries

Sources: Hansson & Partner AB, Ministry of Finance

A decisive factor leading to the declining long-term interests is the low inflation and the lower inflationary expectations. A growing confidence in the consolidation of public finances in EU countries seems to have contributed to lower inflationary expectations. Also the recession that began at the end of 1995 and continued in 1996 is likely to have contributed to the lower long-term interest rates. An additional factor in this connection may be expectations by the financial markets that the monetary union will start according to schedule.

On the basis of the preceding forecasts it seems that there are good prospects for all Member States except Greece to meet the long-term interest rate criterion.

3.3.6 Conclusions

The process towards increased convergence, which has been described in this section, has brought about the conditions for a good economic development in the EU in the future. At the beginning of the 1990s the average inflation rate in the EU was high and the differences among countries large. The majority of EU countries had substantial budget deficits and increasing government debt. Subsequently the deficits have declined, the inflation rate has fallen and the differences among Member States in these respects have shrunk appreciably. These developments have contributed decisively to lower interest rates – both short and long-term – and more stable exchange rates.

The prospects for long-term growth in the EU have been improved owing to increased macroeconomic stability, which has been brought about by the convergence process. By way of example, lower interest rates stimulate investment, which in turn contributes to increasing the possibilities for economic growth. It is essential that the contribution from these developments will be sustainable. The medium-term forecasts point to a continued improvement in public finances in the majority of Member States as well as continued low inflation. In this connection it is important that the budget consolidation measures that are being undertaken have sustainable results. Additional measures will be required in several cases in order to achieve the common commitment to a medium-term budget objective close to balance or in surplus.

The discussion in this section also shows that nearly all Member States have a rate of inflation that is close to the rate that prevails in those countries which have achieved the best performance in terms of price stability. According to the current forecasts, nearly all the countries are also expected to have a deficit near 3 per cent of GDP or less in 1997 and in most cases the deficit is expected to decline further during 1998. However in a few cases additional measures will be required so that the deficit does not increase during 1998. The debt ratio as a share of GDP in many instances is expected to exceed 60 per cent in 1997. However it is expected that a majority of Member States may show a downward trend between 1996 and 1997 and between 1997 and 1998. Finally almost all countries have an interest rate level that is ”near enough” the prevailing level in those countries that have the best performance in terms of price stability. The likelihood that many Member States will meet the convergence criteria has increased and is now quite high.

However the Government here takes no position on the question of which countries meet the convergence criteria or which should participate in the monetary union.

4 Terms for Sweden outside The Monetary Union

4.1 Member States with a Derogation

If Sweden does not participate in the monetary union, Sweden will, in the terminology of the EC Treaty, become a Member State with a derogation. Member States with a derogation will participate in stage three, but on completely different terms than the Member States introducing the euro. Article 109k(3) states which Articles do not apply to Member States with a derogation. In addition to not introducing the single currency, the Member States with a derogation will inter alia:

- retain responsibility for their monetary policy,
- not participate in the operational framework of the ESCB,
- not transfer the right to issue banknotes to the ECB,
- not be subject to the legal provisions of the ECB (decisions, regulations, recommendations or opinions),
- neither participate in any external exchange rate systems nor be subject to any general exchange rate policy orientations,
- not be able to appoint members of the Executive Board of the ECB and their central bank Governor can not be member of the Governing Council of the ECB.

The start of the third stage will, however, also entail changes for Member States with a derogation. Most of the legal framework concerning *economic* policy applies also to Member States with a derogation. One difference compared with the second stage is that it becomes an obligation to avoid excessive deficits in the public finances; in the second stage, Members are to *endeavour* to avoid such deficits.

In the *monetary* area the differences are, naturally, substantial between participating and non-participating Member States. The changes for non-participants compared with the second stage are, inter alia, on the institutional level, as the co-operation in the third stage will take place in the framework of the General Council of the ECB.

In this chapter, the Government describes the conditions that will apply to Member States with a derogation, with the emphasis on legal and institutional matters.

4.2 Economic Policy Co-ordination

There is no transfer of competence with respect to economic policy in the third stage, except for monetary policy. Thus, Member States retain their decision-making competence with respect to fiscal policy and structural policy.

Even if Member States decide and execute most of their economic policies, they are obliged by the Treaty to co-operate. Article 103.1 stipulates that Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council. In addition Article 102a stipulates that Member States shall conduct their economic policies with a view to the achievement of the objectives of the Community.

The forms of co-operation are laid down in the two mentioned Articles of the EC Treaty. They do not differentiate between Member States with and without a derogation. One instrument for co-ordination is the broad guidelines for the economic policies of the Member States and the Community. In these guidelines, which it is the practice to prepare annually, the Council, acting by a qualified majority, formulates the economic policies it regards appropriate for the Member States and the Community. The guidelines are not binding. As a means of bringing pressure to bear, the Council may issue a recommendation to a Member State which is conducting an economic policy that is not consistent with the guidelines or that may jeopardise the function of EMU. Another such means is the possibility of publishing the recommendation. No such recommendation has been issued in the second stage.

On occasion the matter of whether EMU would require far-reaching co-ordination of fiscal policy has been discussed. When proposals have been made to move in this direction, for example, within the framework of the Stability and Growth Pact, Sweden, together with a large majority of Member States, has rejected them. However, Sweden has been positive to discussions and analyses of the fiscal policies of Member States at the EU level.

In the third stage, certain changes in economic policy co-ordination may occur. In June 1997, the European Council asked the ECOFIN Council to study how economic policy co-ordination could be improved. A progress report shall be presented in December 1997. It is still too early to say how this work will develop.

One institutional change is that the Economic and Financial Committee (EFC) will be set up at the start of the third stage. The Monetary Committee will then be dissolved. The functions and composition of the EFC will be similar to those of the Monetary Committee. All the Member States and the ECB will be members of the EFC. It can be expected to become an important body for the dialogue between the government and central bank sides in the third stage. In addition, there are other opportunities for a dialogue between the ECB and the Council. For example, the President of the ECOFIN Council has the right to participate without a vote in the Governing Council of the ECB and the Chairperson of the ECB has the right to participate in the meetings of the ECOFIN Council.

4.3 The Stability and Growth Pact

4.3.1 Background

The objective of the Stability and Growth Pact is to secure lasting budgetary discipline in the third stage of EMU. The Pact consists of both preventive measures – the early warning system, and deterring measures – the excessive deficit procedure. It is based on two regulations and a guiding resolution by the European Council: the Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies (based on Article 103 of the Treaty); the Council Regulation (EC) No 1467/97 of 7 July

1997 on speeding up and clarifying the implementation of the excessive deficit procedure (based on Article 104c of the Treaty) and the Resolution of the European Council on the Stability and Growth Pact, adopted in Amsterdam on 17 June 1997.

The Stability and Growth Pact applies to all Member States, but with important exceptions for Member States not participating in the monetary union.

4.3.2 The Early Warning System

The objective of the early warning system is to prevent excessive deficits. The Council is to be able to give an early warning to a Member State that it needs to take measures in order to prevent the occurrence of an excessive deficit. The Regulation will enter into force on July 1, 1998.

Stability and Convergence Programmes

According to the Regulation, Member States participating in the monetary union are required to prepare stability programmes. Non-participating Member States are to prepare convergence programmes. Stability and convergence programmes are to be submitted before March 1, 1999 and to be updated annually. The programmes and the updated programmes are to be made public.

In both the stability and the convergence programmes, a medium-term objective for the budgetary position is to be stated. Each Member State may decide the objective itself, with due regard to national characteristics, but they have undertaken to aim at an objective of close to balance or surplus. It has been considered that such an objective would enable Member States to deal with normal cyclical variations as well as to avoid excessive deficits.

In the programmes, Member States are to indicate how they intend to proceed in order to adjust the deficit and the debt to the stated objectives. They are to describe the measures being taken as well as the main economic assumptions made.

The programmes are also to contain an assessment of the quantitative effects of the measures on the budget and an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

Member States not participating in the monetary union are to state the medium-term monetary policy objectives in the convergence programmes (see section 4.6.1).

Assessment

The Council shall evaluate the contents of the stability and convergence programmes. It shall examine whether Member States have chosen medium-term budget objectives that provide for a sufficient safety margin to ensure the avoidance of an excessive deficit over a business cycle. It shall also examine whether the measures being taken or proposed are sufficient to achieve the targeted adjustment path towards the objectives and whether the economic assumptions are realistic.

The evaluation is to be carried out within two months of submission of the programmes and the Council then has to deliver opinions on the programmes. If the Council were to consider that the contents or the objectives of a programme have to be strengthened, the Council shall invite the Member State concerned to adjust its programme.

Surveillance

According to the Resolution of the European Council the Member States are responsible for being alert to changes in budgetary developments and for taking appropriate measures at an early stage in order to achieve the objectives of the stability and convergence programmes.

However, as part of the surveillance the Council shall monitor the implementation of the stability and convergence programmes, with a view to identifying actual or expected divergences from the objectives.

If the budget of a Member State diverges significantly from either the medium-term objective, or the proposed adjustment path towards it, the Council shall give the Member State concerned an early warning in the form of a recommendation. The intention is to give a warning in time to prevent the deficit from exceeding the reference value of 3 percent of GDP. The Member States are invited to make public such recommendations at their own initiative.

According to the Resolution of the European Council, Member States, as soon as they receive an early warning, undertake to take the corrective measures they find necessary to prevent the deficit from becoming excessive.

If the divergence were to persist or worsen, the Council shall make a new recommendation to the Member State concerned to take prompt corrective measures. The Council may, as an ultimate means of bringing pressure to bear in this part of the Pact, make the recommendation public.

4.3.3 The Excessive Deficit Procedure

The aim of this part of the Pact is to deter Member States from incurring excessive deficits in their public finances and to ensure that they are corrected promptly, should they occur. In the third stage of EMU, it becomes an obligation to avoid excessive deficits. It is important to note that notices (Article 104c(9)) and sanctions (Article 104c(11)) only apply to Member States participating in the monetary union.

In the following a hypothetical normal excessive deficit procedure is described. The procedure is initiated by submission of data on the public finances before the first of March each year. In reality, the procedure can also be initiated at other times.

Assessment

According to Article 104c(2) of the Treaty, the Commission shall monitor the budgetary situation in Member States in order to assess whether budgetary discipline is being observed. The assessment will be based on the two reference values:

- 3 percent of GDP for the budget deficit, and
- 60 percent of GDP for the consolidated general government gross debt.

The Commission bases its assessment on data for government finances reported by the Member States before the first of March each year.

The Commission is obliged to issue a report if a Member State is considered not to fulfil the deficit or debt criterion or if there is a risk for an excessive deficit. The Economic and Financial Committee shall formulate an opinion on the report. The Commission will then decide whether an excessive deficit exists or may emerge, and it will address an opinion to the Council.

In accordance with Article 104c(6), the Council shall decide on the existence of an excessive deficit in the Member State concerned on a recommendation from the Commission and on the basis of the opinions of the Commission and the Economic and Financial Committee.

There are provisions in the Resolution of the European Council for the purpose of eliminating the risk that the Council would not be able to act, owing to the absence of a basis for a decision from the Commission.

Before taking its decision, the Council is to make an overall assessment of whether an excessive deficit exists. The Council has some room for interpretation while making its assessment. Thus, the decision is not mechanical.

Exceptions from the excessive deficit criterion are specified in the Regulation. If the Council considers the deficit to be exceptional and temporary and to be close to the reference value of 3 percent of GDP, the excessive deficit procedure will not be triggered.

A deficit may be considered exceptional when it is the result of an unusual event outside the control of the Member State concerned and has a major impact on the financial position of the government, or when it is the result of a severe economic downturn, especially in event of an annual fall in real GDP of at least 2 percent.

When making its overall assessment, the Council shall also take into account any observations made by the Member State showing that an annual fall in real GDP of less than 2 percent is nevertheless exceptional in the light of special circumstances, in particular the abruptness of the downturn or the accumulated loss of output relative to past trends. However in the Resolution of the European Council, Member States, in evaluating whether the economic downturn is severe, commit themselves – as a rule – to take as a reference point an annual fall in real GDP of at least 0.75 percent.

The Continuation of the Procedure

The following steps of the procedure are specified in the Regulation:

1. The Council shall decide on the existence of an excessive deficit in a Member State in accordance with Article 104c.6 of the Treaty no later than in May. When it decides that an excessive deficit exists, the Council will at the same time make a recommendation to the Member State concerned. In the Resolution of the European Council, Member States are invited to make the recommendation public on their own initiative.

   The recommendation shall establish a deadline of four months at the most for effective action to be taken by the Member State concerned to correct the deficit.

   In addition, the Council recommendation shall establish a deadline for the correction of the excessive deficit. The correction should be completed in the year following the identification of the excessive deficit unless there are special circumstances. That means that the deficit as a rule should be corrected within two years after it emerges. However, the Council may allow a later deadline.

2. Immediately after the expiry of the deadline of four months, the Council shall decide whether the Member State has taken effective action leading to the correction of the deficit. This decision is thus taken in September at the latest. Publicly announced decisions by the Government of the Member State are to be accepted as a basis for the decision by the Council. Consequently, the measures do not need to be presented in a bill to the Parliament or any similar document. At this point, the Council may make its recommendations public if the Member State has failed to take effective action.

3. Within a month, the Council will make a new assessment of whether the Member State has taken effective action. If the Council finds the measures insufficient, it will give notice to a Member State participating in the monetary union to take the measures for the deficit reduction that the Council deems necessary. This is a stronger summons to rectify the situation than is the recommendation.

4. If the Member State concerned fails to present measures in compliance with the notice, the Council shall decide on sanctions in December at the latest. Thus, a decision on sanctions will be taken within ten months after data on public finances have been reported.

According to the Regulation, the sanction will as a rule initially be a non-interest bearing deposit.

If the participating Member State manages to correct the excessive deficit within two years, the deposit will be repaid, but if it persists, the deposit shall, as a rule, be converted into a fine.

Deposit

The non-interest bearing deposit shall comprise a fixed component equal to 0.2 percent of GDP and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 percent of GDP. A deficit of 6 percent of GPD will result in a deposit equal to 0.2+0.1(6-3) = 0.5 percent of GDP. Any single deposit will not exceed 0.5 percent of GDP.

Each following year, until the decision on the existence of an excessive deficit is abrogated, the Council will assess whether the Member State concerned has taken effective action in response to the Council notice. The decision is not abrogated until the excessive deficit has been fully corrected.

If the Council in its annual assessment finds that the Member State concerned has failed to comply with the notice, the Council will intensify the sanctions by means of an additional deposit, which will be equal to the variable component of the first deposit. The additional deposit may also be converted into a fine if the Member State fails to correct the excessive deficit within two years.

Revenue from deposits and fines

Deposits are to be lodged with the Commission. Interest on deposits and fines shall constitute other revenue referred to in Article 201 of the Treaty and will be distributed among participating Member States without an excessive deficit. Accordingly, it will not be possible to use this revenue to increase expenditures in the EU budget.

4.3.4 Consequences for Sweden

The convergence programmes presented so far by Member States on their own responsibility should be seen as predecessors to the stability and convergence programmes laid down in the Regulation on early warning.

The Swedish Government presented a convergence programme in June 1995. The programme is updated every half year, which is more often than required.

The Riksdag has adopted objectives for the public finances, which by a good margin fulfil the political commitment in the Stability and Growth Pact of a medium-term budgetary objective close to balance or in surplus. Sweden will have a surplus in the fiscal balance, which in the long term shall be equal to 2 per cent of GDP on average over the business cycle. This goal applies from the year 2001. By means of the objective of public finances being close to balance or in surplus, Member States will be able to let the automatic stabilisers work while keeping the deficit within the reference value of 3 percent of GDP.

Sweden's strict budgetary process corresponds well to the requirements of the Stability and Growth Pact. The process includes ongoing controls and reviews of the government finances. It provides for sufficient possibilities to take corrective action. Sweden's reformed budgetary process was introduced independently of the Stability and Growth Pact.

The Stability and Growth Pact has been designed in a way that allows a certain flexibility. According to the Treaty, the Council will make an overall assessment of the deficit of an individual Member State and at the same time, according to the regulation on excessive deficits, take into account particular circumstances of the Member State. The deadline for rectifying the budget deficit may vary. Under certain conditions the reference value of 3 percent of GDP may be exceeded if the deficit stays close to the reference value.

It is important that the Pact be effective in maintaining budgetary discipline in stage three. Deposits and fines give the incentive promptly to correct excessive deficits and maintain budgetary discipline. The Pact has achieved a balance between flexibility and restrictiveness.

4.4 EU Co-operation on Growth and Employment

4.4.1 Development of the Co-operation

In the past few years, the matter of employment has occupied an increasingly prominent position in the work of the EU. It has been discussed at all the recent summits, and at several Council meetings. There is a strong political will to reduce the unacceptably high unemployment in the EU.

At the meeting of the European Council in Brussels in 1993, an Action Plan was adopted based on the Commission's White Paper on *Growth, Competitiveness and Employment*. The conclusions of the Brussels meeting stated that the European Council was to follow up the Action Plan in December each year. Since then the Action Plan has been developed further, both in the regular work of the Council of Ministers and in particular at the meetings of the European Council. The Action Plan covers a number of areas, such as macroeconomic policy, investments in infrastructure in the Community and in individual Member States (inter alia, Trans European Networks), the competitiveness of the business sector, education and structural policy.

The co-operation on employment is primarily among Member States, since they have the decision-making competence in most matters.

At the meeting of the European Council in Essen in December 1994, employment was the main theme. A five-point programme was adopted comprising measures for education and training, employment intensive growth, reduced indirect wage costs, a more effective labour market policy and strengthened support for vulnerable groups. An important result of the meeting was that procedures for surveillance of Member States' employment policies were established. Member States were invited to prepare multiannual national employment programmes. The Council (in its composition of Economic and Finance Ministers and in its composition of Labour Market Ministers) and the Commission were called upon to report annually on developments in the area of employment to the European Council, starting in December 1995.

A first report on employment (the so called Joint Employment Report) was presented before the meeting of the European Council in Madrid in December 1995. At the Madrid meeting, it was reaffirmed that combating unemployment is the most important task of the EU, while concerns were expressed that unemployment had become increasingly structural. It was decided that special efforts should be made to benefit particularly vulnerable groups, such as youth, long-term unemployed and women.

After a debate initiated by the avis from the Commission of 5 June with the title "Action on Employment: A Confidence Pact," the European Council in Florence in June 1996 called upon EU institutions, national, regional and local authorities and the social partners to conduct a coherent and determined policy for growth and employment. At its meetings in Dublin in December 1996 and in Amsterdam in June 1997 the European Council reviewed the Confidence Pact to assess how the strategy had worked.

A second Joint Employment Report was presented at the meeting of the European Council in Dublin in December 1996. Before that, an interim report had been submitted to the European Council at its meeting in Florence. On the basis of the Essen strategy, the European Council in Dublin endorsed the analysis of the Joint Employment Report. To emphasise its commitment to employment, the European Council adopted the Dublin Declaration on Employment. The conclusions from the Dublin meeting contain a reasoning that directly reflects the recommendations in the Joint Report on the need to continue the macroeconomic strategy for economic growth and employment, increase the efforts to modernise goods and labour markets and use new sources of employment, focus on the efficiency of labour markets and on investments in human resources, develop more employment friendly tax and social security systems and strengthen the interaction between macroeconomic and structural policies.

In Dublin a concluding report was submitted on a project that had been initiated by Denmark and Sweden: the mutually beneficial effects of increased co-ordination of macroeconomic and structural policies.

The meeting of the European Council in Amsterdam in June 1997

The fight against unemployment and the question of increased growth and employment were central themes at the meeting of the European Council in Amsterdam in June 1997. The Council reiterated that a coherent and consistent procedure is required to create jobs in Europe, which implies a stability oriented macroeconomic policy, final completion of the internal market, an active employment policy and modernisation of the labour markets. The European Council welcomed the common interim report on employment with the title ”From Words to Action”, that had been prepared by the Council in its two compositions and the Commission and the progress report on the Commission’s Confidence Pact.

The European Council also adopted a separate Resolution on Growth and Employment in addition to the Stability and Growth Pact. The Resolution of the European Council on Growth and Employment contains the following main elements:

- a strengthened co-ordination of employment policies. The broad guidelines of the economic policies of the Member States and of the Community will be strengthened with respect to the parts concerning employment,
- the procedures in the new Title on Employment in the Amsterdam Treaty will be applied immediately to the greatest extent possible,
- an examination of all relevant Community policies from the point of view of employment,
- further action on final completion of the internal market,
- the European Investment Bank and the European Investment Fund are to re-orient and reinforce their activities in areas that are deemed to be important for employment.

In order to keep the momentum in promoting economic growth and combating unemployment the European Council decided to hold an extraordinary meeting on employment under the Luxembourg Presidency in the autumn of 1997.

4.4.2 The New Title on Employment in the Amsterdam Treaty

Background

An overall objective of the Intergovernmental Conference that preceded the Amsterdam Treaty was to change European Union so that it will better live up to the expectations of its citizens. The persistently high unemployment in Europe was a particularly important matter in that context.

The Swedish Government has given a very high priority to the matter of employment in European co-operation. Therefore, employment was also a very important matter for Sweden at the Intergovernmental Conference. In September 1995 Sweden took a first initiative on employment. In June 1996 the Swedish ideas were given a more concrete form at the Intergovernmental Conference and in September that year Sweden presented a proposal for a text for a new Title on Employment.

The result of the Intergovernmental Conference is a significant achievement for Sweden. Agreement was reached on a new Title on Employment, which is very similar to the Swedish proposal, to be inserted into the Treaty. In this section the contents of the new Title are described.

Objectives

The objectives in the Treaties are reinforced, partly by changes in Article B in the Treaty on European Union and in Articles 2 and 3 in the EC Treaty, and partly by the objectives laid down in the new Title.

The changes entail, inter alia, that Member States and the Community are to work towards developing a co-ordinated strategy for employment. Employment is to be taken into account in the preparation and implementation of all Community policies. In this way, employment is given a high priority in the work of the Community.

Co-ordination and Surveillance

Member States will retain their present competence in employment. However, the mechanisms for co-ordination and surveillance will be strengthened. The change of the Treaty does not imply that employment policies will be harmonised at the Community level.

In this way, employment policy is treated in a manner that resembles, inter alia, budget discipline. This is in line with the Government's view that the surveillance of employment policy must be given the same weight and concrete form that is applied to the surveillance of other economic policies.

The procedure laid down in the Treaty obliges the European Council to examine thoroughly the matter of employment once every year. The deliberations of the European Council are to be based on a joint annual report from the Council and the Commission on the employment situation in the Community.

The Council is to prepare annual guidelines of employment policy. They are to be consistent with the broad guidelines for economic policies in accordance with Article 103(2) of the EC Treaty.

On the basis of the employment guidelines the Council is to evaluate the implementation of employment policies in Member States. The national reports of Member States on the employment situation will be a central part of the surveillance. If a Member State conducts a policy that the Council deems to be incompatible with the guidelines of employment policies, the Council may issue a recommendation to the Member State to adjust its policy. As a further means of bringing pressure to bear the Council may make the recommendation public.

Incentive Measures

The Council will also be able to decide on so called incentive measures to encourage co-operation between Member States and support their work on employment. However, this does not imply that fiscal policy stimulation may be undertaken. Neither should any harmonisation of the laws or other regulations of Member States be made. The support measures aim primarily at an exchange of information and experiences, especially by way of pilot projects. The duration of these measures should not exceed five years.

The Employment Committee

An institutional change ensuing from the change in the Treaty is the establishment of an advisory Employment Committee with two members from each Member State and the Commission. The Committee will be given a prominent role. It is to further a coherent view and a better co-ordination of employment policies among Member States. The Committee is also to promote a close co-operation between the social partners.

4.4.3 Sweden's Priorities

Even outside the monetary union, the Government will continue to be a primary force in the co-operation for increased employment and lower unemployment. In this area the regulatory framework of the EU does not make any distinction between Member States participating in the monetary union and non-participating Member States.

Employment policy is an integral part of economic policy. Sound public finances and stable prices are the foundation for sustainable economic growth and high employment. Measures to promote a labour market that is flexible and functions well, to strengthen education and competence building, and to complete and further develop the internal market are important. The Government attaches great importance to the new Title on Employment.

Employment policy is principally a national matter. Active European co-operation on growth and employment can strengthen the national effort.

4.5 The Status of Sveriges Riksbank and Its Participation in the ESCB

If Sweden does not participate in the monetary union, the right to make decisions on monetary policy will remain with Sveriges Riksbank and accordingly this right will not be transferred to the European System of Central Banks (ESCB). The central banks in those Member States that do not participate in the monetary union will, notwithstanding, have some limited role in the ESCB. This section gives a brief account of what the prospective role of the Riksbank in this respect is likely to be in the event that Sweden does not participate in the monetary union.

4.5.1 The Status of the Riksbank

According to Article 108 in the EC Treaty, every Member State will, by the time that the ESCB is established, that is, immediately after July 1, 1998 at the latest, ensure that this legislation conforms to the EC Treaty. This obligation applies to all Member States except the United Kingdom, even if they do not participate in the monetary union. Sweden must accordingly, irrespective of whether or not it participates in the monetary union, fulfil certain requirements in the Treaty concerning the status of the Riksbank.

At the time of the deliberations of the political party leaders in autumn 1996 it was decided that constitutional and other legal matters related to the future status of the Riksbank would be considered by a working group consisting of representatives from all the parties in the Riksdag. The discussions resulted in a five-party agreement that was reported in the Ministry’s governmental memorandum on the status of the Riksbank (Ds 1997:50). After the circulation of this governmental memorandum for consideration by the parties concerned, political or other, the Government decided on October 2, 1997 on a submission to the Council on Legislation. The proposal has also been submitted to EMI for review. A bill on the subject is expected to be presented to the Riksdag in November 1997.

The basis of the Government’s proposal in the submission to the Council on Legislation is that the Riksbank will have responsibility for the monetary policy and the independence of the Riksbank will be strengthened and the harmonisation of Swedish law should be accomplished in such a way that it represents those provisions that are in force in Sweden. Even if it might be possible under EC law to dispense with adjustment of Swedish law, considering that EC law enters into effect directly, amendments to the Constitution Act will be made from the standpoint that such amendments should reflect the essential elements of how Sweden is governed.

The Government has proposed that the objective for monetary policy is to be the maintenance of the value of money. This objective is stated in the Sveriges Riksbank Act (1988:1385). As an authority under the Riksdag, the Riksbank will, in addition – without disregarding the price stability objective – support the objectives of general economic policy aimed at achieving sustainable growth and high employment.

Further the Government has proposed that the responsibility for overall exchange rate policy matters be transferred from the Riksbank to the Government. The Government will then decide the system to be used for determining the value of the krona in relation to foreign currencies (the exhange rate system). This transfer requires amendments to the Constitution Act. The provisions on exchange rate policy matters will be laid out in a new law on exchange rate policy. The Riksbank will decide on central rates and fluctuation bands in a system of fixed exchange rates and on the practical application of exchange rate policy in a system with floating exchange rates.

With respect to the management structure of the Riksbank, the Government has proposed that the Governing Board will be given a supervisory function. The duties of the Governing Board are stated in the Sveriges Riksbank Act. An Executive Board with six representatives who are employed fulltime will be appointed to decide all matters of monetary policy and manage the Riksbank. The Executive Board will be appointed by the Governing Board. Except for the initial period, the term for each member of the Executive Board is six years.

Under the proposal the Riksdag will appoint the members of the Governing Board, approve the Profit and Loss Account and balance sheet and grant discharge from liability to the Governing Board and the Executive Board. The Governing Board will consist of eleven members and an equal number of alternates. Their term of appointment will be four years. Among the duties of the Governing Board are, inter alia, the appointment of the Governor of the Riksbank, the Deputy Governors and the rest of the Executive Board. The Governing Board will present a proposal to the Riksdag on the allocation of the Riksbank's profit.

In addition the Government has proposed that an express prohibition be included in the Constitution Act forbidding the authorities from prescribing how the Riksbank will decide monetary policy issues. A related provision that members of the Executive Board will not seek or take instructions in the performance of their monetary policy duties will be included in the Sveriges Riksbank Act. The right of the Riksbank to decide on the central rate and the fluctuation band has great importance in enabling the Riksbank to achieve its price stability objective and therefore is crucial for monetary policy. These decisions will therefore be included in the prohibition against instruction.

To ensure public control and supervision of the Riksbank's activities in the monetary policy area, the Government has proposed that the Bank shall inform the Government before all important monetary policy decisions. In addition the chairperson and vicechairperson of the Governing Board of the Riksbank have the right to attend meetings of the Executive Board and to express opinions at them, but they do not have the right to propose measures or to vote. In addition the Riksbank shall at least twice a year, present a report to the Riksdag on their conduct of monetary policy.

The new provisions shall, according to the proposal in the submission to the Council on Legislation, enter into force on January 1, 1999.

4.5.2 Participation in the ESCB

Under Article 14.3 of the statutes of the ESCB, the national central banks of the Member States participating in the monetary union form an integral part of the ESCB and will act in accordance with the guidelines and instructions of the European Central Bank (ECB). The ESCB admittedly also comprises the central banks of the Member States not participating in the monetary union, but they have much less influence on the system of central banks. For example, if Sweden does not participate in the monetary union, the Governor of the Riksbank will have no seat in the Governing Council of the ECB and Sweden will not take part in appointing members of the Executive Board of the ECB.

As long as there are Member States not participating in the monetary union, according to Article 109l(3) of the Treaty, the ECB will have a decision-making body in addition to the Governing Council and the Executive Board. This third decision-making body will be called the General Council of the ECB. The General Council will comprise the President and the Vice-President of the ECB and the Central Bank Governors of all Member States. Consequently, the Governor of Sveriges Riksbank will be a member of the General Council even if Sweden remains outside the monetary union.

The responsibilities of the General Council are regulated in detail in Article 47 of the statute of the ESCB. It says that the Governing Council shall contribute to the preparations for non-participants joining the monetary union. These preparations include fixing the exchange rates of their currencies in connection with their entry. The General Council shall also contribute by advising and giving opinions on Community and national legislation within the competence of the ECB. It will also give opinions on Community legislation on supervision of credit institutions and the stability of the financial system.

In addition, the General Council shall also contribute to the collection of statistic report activity of the ECB, standardisation of book keeping and reporting of the transactions of national central banks, establishment of the key for the capital subscriptions and laying down the conditions of employment of the staff of the ECB.

The General Council has no function with respect to the common monetary policy. However, non-participating Member States may be informed through the General Council about the activity of the Governing Council, including decisions on monetary policy. According to Article 47.4 of the ESCB statute, the President of the ECB shall inform the General Council of decisions of the Governing Council.

At present, discussions are in progress within EMI about the rights of Member States with a derogation to participate in committees and working groups of the ECB. It is impossible today to predict the result of these discussions.

If Sweden does not join the monetary union, its participation in the General Council will be of great importance, since it will give Sweden access to information on the activities of the ECB.

4.5.3 Collection of Statistical Information

In order to undertake the tasks of the ESCB, the ECB shall, under Article 5 of the Statute of the ESCB, collect the necessary statistical information either from the competent national authorities or directly from economic agents. In this work, the ECB will be assisted by the national central banks. More detailed provisions for the collection of this information will be laid down in regulations of the Council and regulations, decisions etc. of the ECB.

Article 5 applies to all Member States, which means that all Member States, irrespective of whether they participate in the monetary union or not, are to contribute to the harmonisation and to take the measures necessary in order to adjust their statistical systems to the common requirements.

Member States with a derogation will not be bound by Regulations issued by the ECB based on the upcoming Council Regulation on statistical information. In practice the requirement for harmonisation under Article 5 may still make it appropriate for non-participating Member States to make the corresponding adjustments in their statistical systems to some extent.

So far, no requirements and wishes concerning reporting of statistical information by the Riksbank to the ECB have been expressed. However, in order to make possible an effective common analysis within the ECB it is reasonable to expect the Riksbank to make some statistical information available to the ECB even if Sweden does not participate in the monetary union.

4.5.4 Consultation of the ECB on Proposed Community Acts

According to Article 105(4) of the EC Treaty, the ECB shall be consulted on any proposed Community act in its field of competence. This obligation to consult the ECB is applicable to all Member States, except for the United Kingdom, even if they do not participate in the monetary union. A similar provision for consulting the EMI already exists. The Council is expected to adopt a regulation on this matter before the start of the monetary union.

4.6 Exchange Rate Policy of Member States with a Derogation

4.6.1 General Rules for the Exchange Rate Policy of Member States with a Derogation

A basic principle, laid down in Article 109m of the EC Treaty, is that until the beginning of the third stage, each Member State shall treat its exchange rate policy as a matter of common interest. From the beginning of the third stage, the Article will continue to apply to Member States with a derogation.

Article 109m does not imply any legal obligation to join the ERM. Joining the ERM or the ERM 2 is a possible way, but not the only way of fulfilling the committment of Article 109m.

During the negotiations on the ERM 2, it was discussed what should apply to Member States with a derogation not participating in the ERM 2. The position of Sweden was that what is most important is that the economic policy is oriented towards stability, so that excessive exchange rate fluctuations can be avoided. One experience from the ERM crisis in 1992-93 and the fall of the Swedish krona in 1992 is that a stable exchange rate must be underpinned by stability in economic policy. A stable exchange rate cannot be maintained unless it is supported by economic fundamentals. This approach was very much reflected in the conclusions of the meeting of the European Council in Dublin in December 1996. It is stated in these conclusions that it is by stability oriented economic policies that Article 109m is made effective. Accordingly, this does not have to be made by way of a fixed exchange rate regime. The Dublin Agreement also includes the provision that Member States with a floating exchange rate are to present their policies in a convergence program so as to enable appropriate surveillance.

The procedures for surveillance of this part of economic policy were made concrete in connection with the negotiations on the Stability and Growth Pact. The provisions are laid down in the Council Regulation 97/1466/EC on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies, Articles 7.2 and 10, second paragraph. Non-participating Member States are to prepare convergence programmes. In addition to information on public finances, such programmes shall present information on ”the medium-term monetary policy objectives; the relationship of those objectives to price and exchange rate stability”. In Article 10, the second paragraph, it is stated: ”In addition, the Council shall monitor the economic policies of the non-participating Member States in the light of convergence programme objectives with a view to ensure that their policies are geared to stability and thus to avoid real exchange rate misalignments and excessive nominal exchange rate fluctuations.”

Those rules do not entail any commitment to have a fixed exchange rate or an objective for the exchange rate policy or the exchange rate. This means that Sweden can continue to have a floating exchange rate and a monetary policy with an inflation target. However, the economic policies of Member States outside the monetary union will be subject to surveillance. The surveillance will be directed at the economic fundamentals underpinning a stable exchange rate, above all sound public finances and price stability. Consequently, the convergence programme, which Sweden will later submit in accordance with the Stability and Growth Pact is to contain the information on the medium-term monetary policy objectives, mentioned previously.

4.6.2 The ERM 2

At the meeting of the European Council in Madrid in December 1995 the ECOFIN Council was invited to study the relations between the monetary union and Member States with a derogation. This invitation was followed by extensive work in the Council, the Commission and the EMI to prepare an exchange rate mechanism that can start functioning from the beginning of stage three. The European Council in Amsterdam adopted a Resolution on the ERM 2 in June 1997.

An important motive for establishing the ERM 2 was to protect the single market from being endangered by real exchange rate misalignments or by excessive nominal exchange rate fluctuations.

The ERM 2 has a number of similarities with the present ERM. It is a co-operation between Member States. It is based on a central rate and a fluctuation band for the exchange rate. At the margins, interventions by the central banks in order to defend the rates are mandatory. But there are some differences. These differences are primarily due to the lessons learnt from the major strains on the ERM caused by the turbulence in the foreign exchange markets in 1992 and 1993, but they are also based on other experiences of the functioning of the ERM. Central rates will only be defined against the euro and not between all the participating currencies, as in the present ERM The price stability objectives for the ECB and the national central banks are explicitly made superior to the objective of defending the central rates by the right to suspend interventions if they were to conflict with the price stability objectives.

It is strongly emphasised in the introduction to the Resolution on the ERM 2 that stability oriented economic policies are necessary for sustainable exchange rate stability. All Member States must pursue monetary policies directed towards price stability. Furthermore, it is stressed that sound fiscal and structural policies are equally essential for sustainable exchange rate stability.

In the negotiations on the ERM 2, Sweden attached great importance to voluntary participation, as in the present ERM. This was also the outcome of the negotiations; the resolution states that participation will be voluntary. Furthermore, it is stated that Member States with a derogation can be expected to join the mechanism.

The standard fluctuation band will be plus/minus 15 per cent around the central rate. Sweden recommended selecting this width for the bands; Sweden also recommended that it should be laid down in the Resolution. It is the same percentage as in the present ERM. In practice, the ERM 2 has more flexibility because the central rates are defined only against the euro, which allows the other participating currencies to fluctuate considerably more against each other. There is no obligation in the Resolution for the participants in the mechanism to try to keep exchange rates within narrower bands than the standard ones.

Central rates and the standard fluctuation band can be changed by a procedure similar to the one in force at present. This means a procedure whereby the participants in the mechanism including the ECB decide by mutual agreement following a procedure involving the Commission and the Economic and Financial Committee. All Member States are entitled to participate in meetings on these matters. Decisions are taken by mutual agreement, which is, in principle, unanimous. It is stated in the Resolution that the standard fluctuation band will be relatively wide. A Member State participating in the mechanism can in practice veto an undesirable narrowing of the standard band.

An important feature of the ERM 2 is that all parties to the mutual agreement, including the ECB, will have the right to initiate a confidential procedure aimed at reconsidering central rates. This procedure was established because experience showed that central rate realignments were avoided for too long or were insufficient in view of economic fundamentals. The idea now is that central rates shall not be allowed to deviate too much from the real equilibrium rates.

Fluctuation bands narrower than the standard one can be agreed at the request of a Member State. It may be the case that a Member State wishes a closer link to the euro than is implied by the standard band. Such narrower bands should be considered taking into account the degree of convergence of the Member State concerned. Decisions on a narrower band are taken according to a somewhat different procedure. The decision is taken only by the ministers of euro area Member States, the ECB and the minister and central bank governor of the Member State concerned, whereas other parties participate in the procedure without the right to vote. Narrower bands will not constitute a requirement for qualifying for participation in the monetary union. Sweden attached importance to this in the negotiation.

4.6.3 External Aspects of EMU

The Institutional Framework

The exchange rate policy of the monetary union is regulated in Article 109 of the Treaty. The general principles are that exchange rate policies shall be formulated in close co-operation between the parties concerned and that the objective of price stability is defended. The Council can decide on exchange rate policy by:

- formal agreements on an exchange rate system or
- general orientations for exchange rate policy.

The ECB is given significant influence in these decisions. In addition, the ECB plays an important role by being responsible for the implementation of exchange rate policy (interventions and management of foreign exchange reserves).

A formal agreement on an exchange rate system may be considered if, for example, an equivalent to the *Bretton Woods System* were to be established. The Council has the ultimate responsibility for concluding such agreements. The Council takes its decision on a recommendation from the ECB or the Commission. Only participating Member States have the right to vote and the decision has to be unanimous. Non-participating Member States are entitled to be present and make comments. The Council takes decisions on central rates, but a qualified majority is sufficient (two-thirds of the weighted votes of the participating Member States). Central rates may be adopted or adjusted, and they may even be abandoned, that is, the euro may be allowed to float.

In the absence of a formal agreement the Council may formulate general orientations for exchange rate policy. However, the ECB is not bound by such orientations, which cannot be in conflict with the objective of price stability.

At the summit in Amsterdam the Council and the Commission were invited to study effective ways of implementing the provisions of Article 109 and in particular a possible formulation of general orientations of exchange rate policy in relation to third countries. This work is still in progress.

It remains to be seen what kind of exchange rate system will be established for the euro. At present, it must be regarded as unlikely that any kind of fixed rate arrangement, formal or informal, would be introduced in relation to another currency, such as the U.S. dollar.

The Role of the Euro in the International Monetary System

The number and identity of the Member States that will join the monetary union is still unclear. At present, it is difficult to predict the future importance of the euro. In this section, an attempt is made to highlight a number of factors that may affect the role of the euro in the international monetary system.

It is likely that expectations about the development of economic fundamentals in the monetary union are going to play an important role for the development of the euro, at least in the long term. How these expectations will be shaped is difficult to predict. Factors such as a far-reaching independence of the ECB and strict implementation of the price stability objective and the Stability and Growth Pact would speak for a strong euro. On the other hand, it may take some time for the ECB to establish credibility for its policy, which could lead to a weak exchange rate for the euro.

In the initial year of the monetary union, a reallocation of portfolio investments may affect the exchange rate of the euro. Above all, the creation of a deep and liquid financial market in euros could lead to increased demand for the euro in private portfolios. In addition, the demand for investments in euros for official portfolios could grow as a result of changes in the foreign exchange reserves of central banks. This could lead to an upward pressure on the exchange rate of the euro. At the same time, counteracting factors could be imagined. The euro market could attract debt managers, who may want to increase the share of euros, in which case the supply of euros would increase. The net effect of the reallocation of portfolios is therefore uncertain.

The monetary union will be a much more closed currency area than are the individual Member States. As a consequence, the importance of the exchange rate to demand in the economy is likely to diminish significantly for countries joining the monetary union. It would seem natural to give less weight to the exchange rate in the formulation of monetary policy. This could lead to larger exchange rate fluctuations than are experienced by European currencies at present.

International Representation

The establishment of the monetary union is likely to lead to changes in the representation of the EU in international organisations. It is still unclear to what extent the Community will represent Member States in international fora such as the IMF, the G7 and the OECD. Since a great many matters discussed in these fora are not of a Community nature, national representation is likely to continue after January 1, 1999.

If a country outside the EU would intend to discuss exchange rate policy with representatives of the monetary union, it is still not evident what EU body should conduct the negotiations. The distribution of responsibilities in the Treaty between the Council, the Commission and the ECB does not provide a clear answer to that question. Any body conducting the negotiations with a third country would, however have to represent the interests of the Community and its position must have the support of the Community bodies concerned.

Consequences for Sweden

As is evident from what has been said previously, it is still unclear what role the euro will play in the international monetary system, what kind of exchange rate regime will apply to the euro and how the monetary union will be represented internationally. The global economic integration and developments within the EU have great significance for Sweden's economic development and their significance is likely to increase over time. As a part of these developments, the exchange rate policy of the monetary union will have consequences for Sweden even if it remains outside the monetary union.

As regards the representation of the monetary union in international fora, Sweden should not contribute to changing the present national representation in the IMF, the G10 or the OECD. Such a change would diminish Sweden's influence in these organisations.

4.7 The Legal Framework for the Introduction of the Euro

In order to create a legal framework for the use of the single currency – the euro – two Council Regulations were prepared. One of the Regulations, which is based on Article 235 of the EC Treaty and was adopted by the Council on June 17, 1997 (Council Regulation (EC) No 1103/97), contains certain provisions relating to the introduction of the euro. The other Regulation, which is based on Article 109l.4 of the Treaty, is to be adopted by Member States which are going to participate in the monetary union from the start on January 1, 1999. In July 1997, the Council adopted a draft of this Regulation on the introduction of the euro. The draft has been published as an appendix to a Council Resolution (the Resolution of the European Council of July 7, 1997 on the legal framework for the introduction of the euro [97/C 236/04])

The Regulation in accordance with Article 235 contains certain provisions that have been considered urgent, inter alia, for reasons of legal rights. It concerns rules for the replacement of the ecu by the euro at a rate of one euro to one ecu, the continuity of contracts and rules for rounding. The Regulation is binding and directly applicable in all Member States. Thus, it is applicable in every Member State irrespective of whether or not it participates in the monetary union.

Concerning the official ecu it is stipulated that every reference in a legal instrument to the ecu, as defined in Regulation (EC) No 3320/94, shall be replaced by a reference to the euro at a rate of one euro to one ecu. References in a legal instrument to the ecu without such a definition shall be presumed to be references to the ecu as defined in the aforementioned Council Regulation. Legal instruments shall mean legislative and statutory provisions, acts of administration, judicial decisions, contracts, unilateral legal acts, payment instruments other than banknotes and coins, and other instruments with legal effect. Contracts shall include all types of contracts, irrespective of the way in which they were concluded.

In order to secure continued validity of contracts – continuity of contracts – when the euro is introduced, there is a provision in the regulation stating that the introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument. However, the provision does not prevent the parties from agreeing on something else.

Finally, the Regulation according to Article 235 contains two provisions on how conversion between the euro and the national currencies shall be made and how rounding is to be made in connection with such conversion.

The Regulation in accordance with Article 109l(4) of the Treaty is binding and directly applicable in Member States with the exception of the opt-outs for Denmark and the United Kingdom and for Member States which will be given a derogation from participating in the monetary union according to Article 109k. Certain provisions of the Regulation must however, be regarded as indirectly applicable and be respected also in Member States not participating in the monetary union. This relates, for example, to the provisions on the replacement of the currencies of the participating Member States by the euro and the keeping of the national currencies as non-decimal expressions of the euro during the transition period.

The Regulation in accordance with Article 109l(4) begins with two provisions stating that the euro shall be the currency of the participating Member States and shall be substituted for the currency of each participating Member State at the agreed conversion rate. Furthermore, there are certain provisions that will be applicable during the so called transition period, which starts on January 1, 1999 and ends on December 31, 2001. The main principle is that during this period there will be no compulsion to use the euro and no prohibition against using it. In transactions between accounts the payer will be able to choose either the euro or the national currency irrespective of which currency the account of the payee is denominated in. Any conversion that may be required will be made by the bank.

It is, however, possible for Member States to take measures that deviate from the main principle of no compulsion, no prohibition with respect to using the euro in a few cases. It concerns measures to change the currency of denomination of outstanding debts (redenomination) and measures to make it possible for i.a. exchanges, markets and clearing and settlement systems to use euros instead of national currencies. Other provisions prescribing the use of the euro may only be adopted according to a time frame that has been established by Community law.

The regulation also contains provisions on euro-denominated banknotes and coins. The exact time for putting them into circulation has not yet been decided. When the Regulation is adopted – that is, in 1998 at the latest – a date will be set. The banknotes and coins denominated in euro will become legal tender in the participating Member States. The national banknotes and coins will retain their status as legal tender for no more than six months after the expiration of the transition period. Any Member State can decide to shorten this period. This means that two types of legal tender can exist in parallel for some time. Every Member State may decide for itself for how long the national notes and coins will be convertible into euros after having ceased being legal tender.

4.8 Joining The Monetary Union after January 1, 1999

A Member State with a derogation fulfilling the necessary conditions can join the monetary union at any time. The procedure for this is laid down in Articles 109k.2 and 109l.5 of the EC Treaty. The procedure is in principle the same as that when the first group of participants in the monetary union is selected, but some differences exist. At the informal ECOFIN meeting in Noordwijk in April 1997, matters related to joining the monetary union after January 1, 1999 were discussed. According to the Government’s assessment, the following can be expected to apply.

At least once every two years the Commission and the ECB shall report to the Council on the progress made by Member States in the fulfilment of their obligations with respect to the achievement of EMU in accordance with the procedure laid down in Article 109j(1). The reports are to examine how the convergence criteria are met as well as certain other conditions, such as the independence of the national central bank. Such reports can also be prepared at the request of the Member State concerned. Consequently, Sweden will be the subject of a report every second year. Sweden also has the right to request a report.

The reports may be followed by an assessment by the Council. If the ECOFIN Council finds that the Member State concerned fulfils the necessary conditions for the introduction of the euro, the derogation will be abrogated. The decision will be taken by qualified majority and all Member States have the right to vote. The decision will be preceded by discussions of the Council in the composition of Heads of State and Government and by consultations with the European Parliament. It must be assumed that the national decision-making process will be respected in connection with an entry after January 1, 1999.

The Treaty does not differentiate between the conditions of entry between Member States participating from the start and those joining later. The European Council made this clear at its meeting in Madrid in December 1995. A principle of equal treatment applies.

The Treaty leaves some room for interpretation of the convergence criteria. It can be expected that when the Council selects the first group of participants in the monetary union in the spring of 1998, the interpretation of the criteria will be clarified. The interpretation made then will also govern how the criteria will be applied later on. Thus, when Member States are examined for joining the monetary union after January 1, 1999, the convergence criteria should be interpreted neither stricter, nor looser, compared to Member States joining in the first group.

Another matter concerning Member States joining at a later stage is related to the different phases in the changeover to the euro. For the first group of participants, the European Council defined these phases in December 1995 in Madrid. It is likely that there will be some flexibility in this respect for countries joining later. They would certainly not be allowed to use more time for completing the changeover to the euro, but they could make the changeover in a shorter time, if it were to prove possible and appropriate. The changeover could be adapted to the conditions and preferences of the country concerned. Against this background, the following may be said about the different stages of the changeover.

Phase A, from the decision to abrogate a derogation to the adoption of the single currency, can probably be shortened compared with the first group. The ESCB will already be functioning fully. Some time may be needed for national preparations, inter alia, for legislation and to give private economic actors time for remaining preparations.

Phase B is introduced when the Council unanimously decides the conversion rate between the euro and the currency of the Member State concerned. Participating Member States and the Member State concerned are entitled to vote in this decision. The Community will assume responsability over the monetary policy. For the first group, this phase may last up to three years. It could probably be made much shorter for Member States joining later, inter alia, since they could benefit from the experiences of the first group of participants.

The final Phase C can last no longer than six months for the first group. In this phase, banknotes and coins denominated in euros are substituted for banknotes and coins denominated in national currency and become legal tender. During a short period, however, the national bank notes and coins remain legal tender.

Considerations on a future Swedish participation in the monetary union are found in section 7.2. These matters are also discussed in section 5.2 on Sweden’s practical preparations.

5 Sweden’s Preparations for Stage Three

5.1 The Swedish Convergence Programme

The convergence criteria defined in the EC Treaty, are expressions of a sound economic policy irrespective of position on participation in Economic and Monetary Union (EMU). The development of Sweden’s economy since Sweden presented its first convergence programme in June 1995 has been favourable: falling inflation and interest rates, a strengthened exchange rate and a major improvement in public finances. Sweden’s economy has achieved a sufficient degree of strength and sustainable stability to be able to participate in the monetary union.

5.1.1 Background

A major part of Sweden’s preparations before stage three of EMU is the convergence programme that the Swedish Government presented in 1995. This programme, inter alia, set specific, far-reaching goals for the consolidation of the public finances.

During the first stage of EMU, it was the responsibility of the Member States to undertake a convergence programme. These programmes would lay the foundation for an assessment of the progress that had been made on the matter of convergence in economic development, especially with reference to price stability and sound public finances, which are necessary before a common currency can be introduced. During stage two of EMU, convergence programmes are a voluntary commitment, but the Member States have agreed in the ECOFIN Council that it is desirable to carry on with convergence programmes. All Member States (except Luxembourg) have chosen to present such programmes during stage two.

According to a recommendation from the ECOFIN Council the programmes are to cover a period of at least three years and include targets for economic policy which are to be defined as precisely as possible. In addition the programmes should state what measures have been taken and what measures have been announced in order to achieve these targets. They ought also to include what further measures will be undertaken, if required.

As a new member of the EU, Sweden presented its first convergence programme in June 1995. The convergence programme builds on the economic policy that the Government and the Riksdag decided during the 1994/95 session of the Riksdag, which inter alia included specific targets for the public finances. A substantial majority of members of the Riksdag supported the programme.

The ECOFIN Council in a statement on September 18, 1995 welcomed the Swedish convergence programme. The Council was of the opinion that the programme, based on realistic assumptions, presented a strategy for achieving the convergence criteria and restoring stability to the Swedish economy and thus created conditions for sustained growth in production and employment. The Council noted especially the ambitious targets for the public finances.

In the convergence programme it was announced that there would be follow-ups in the form of semi-annual reviews. Such reviews have been presented on the following five occasions:

- In November 1995 in connection with the Government Bill, A Policy for Work, Welfare and Growth (Government Bill 1995/96:25, Appendix 2).
- In April 1996 in connection with the Spring Budget Bill (Government Bill 1995/96:150, Appendix 2).
- In September 1996 in connection with the 1997 Budget Bill (Government Bill 1996/97:1, Appendix 3).
- In April 1997 in connection with the Spring Budget Bill (Government Bill 1996/97:150, Appendix 2).
- In September 1997 in connection with the Budget Bill (Government Bill 1997/98:1, Appendix 3).

5.1.2 The Convergence Programme

In the convergence programme it is stated that the Government and the Riksdag will later take a position on Sweden's participation in stage three of EMU and that this position would be decided in the light of new developments and in accordance with the Treaty. At the same time it is said that the convergence criteria that have been formulated in the EC Treaty are expressions of a sound economic policy and lay the foundation for strong growth and employment.

The goal for economic policy will therefore be, irrespective of the final position on Sweden's participation in the monetary union, to meet the convergence criteria. This policy direction is a condition for the achievement of the goal of increased employment and reduced unemployment. Furthermore as a special goal, it is noted that economic growth should be in forms that do not increase the deterioration of the environment or the environmental debt.

At the time that the convergence programme was presented, there was a fundamental imbalance in public finances, with a deficit equivalent to 10 per cent of GDP in 1994. Against this background, fiscal policy was directed at consolidating public finances. Three specific targets were set for budget policy:

- The government debt will be stabilised as a share of GDP by 1996 at the latest.
- The deficit in public finances in 1997 cannot exceed 3 per cent of GDP.
- A balance in public finances will be achieved in 1998.

To achieve these targets the Riksdag decided on a consolidation programme with measures that would strengthen public finances on a sustainable basis by SEK 118 billion in 1998, equivalent to 7.5 per cent of GDP. The reinforcement of the revenue side would amount to more than SEK 57 billion and the reduction in expenditures would be more than SEK 60 billion. It is stated in the programme that additional measures may need to be taken. Further it will be announced that there ought to be a sale of state owned assets equivalent to SEK 50 billion.

With respect to monetary policy, the programme concurs with the Riksbank’s target of an annual rate of inflation amounting to 2 per cent, with a tolerance of plus or minus 1 percentage point. Additionally, certain institutional changes will be announced, inter alia, with respect to the Riksbank’s independence.

In the convergence programme an estimate of the economic development up to the year 2000, which was made in June 1995, was presented (table 5.1). From this estimate it is clear, inter alia, that the proposed budget strengthening measures were not enough to achieve the stated goals. However at that time, the Government refrained from proposing further measures, given that the underlying assumptions on economic growth could be considered moderate.

5.1.3 Convergence Programme Reviews

The convergence programme presents the path planned for the development of Sweden’s economy. The Government declared that it plans to follow up the programme every half year in the form of public reviews. The reviews will be the basis for economic policy adjustments if growth varies from the intended course. The reviews have focused on the convergence criteria. The targets for employment and the environment have been followed up in other contexts.

The November 1995 Review

The first review showed a picture of economic growth that was more favourable in many respects than that assumed in the convergence programme. Price increases were subsiding and inflationary expectations were dampened. The interest rates on bonds fell faster and the krona strengthened more than was anticipated in the forecasts that formed the basis of the convergence programme. However, registered unemployment sank more slowly than expected. In total these changes helped to create a better starting point for the improvement of public finances. The deficit in public finances for 1997 was estimated to fall below the reference value of 3 per cent of GDP. The gross public debt was estimated to have stabilised as early as 1995 at a level equivalent to 80 per cent of GDP, which was more than 4 percentage points lower than the estimate in the convergence programme. Against this background, the Government concluded that there was no reason to propose additional budget strengthening measures.

The April 1996 Review

Towards the end of 1995 economic conditions, both in Sweden and abroad, were weakening and a downward revision of the forecasts for 1996 and 1997 was necessary. The deficit in public finances for 1997 was estimated to amount to 3.3 per cent of GDP and 0.8 per cent, or SEK 14 billion for 1998. The consolidated gross debt measured as a share of GDP increased by a couple of percentage points between 1995 and 1996.

Against this background the Government proposed in the Spring Budget Bill of 1996 an augmentation of the consolidation programme by SEK 8 billion in sustainable budget strengthening measures, for a total of SEK 126 billion or from 7.5 to 8 per cent of GDP. In addition SEK 6 billion in temporary budget strengthening measures were proposed.

The September 1996 Review

The forecast with respect to economic development led to no further measures. After the measures that had been proposed in the Spring Budget Bill and approved by the Riksdag, the deficit in public finances for 1997 was estimated to amount to 2.6 per cent of GDP and for 1998, to be eliminated. The gross public debt between 1995 and 1996 was forecast to decline from 80 per cent to 78 per cent of GDP.

The April 1997 Review

Despite a certain unrest in the financial markets and falling employment at the beginning of the year there were signs of a recovery in the economy during 1997. The budget deficit was estimated to be below the 3 per cent reference value by a comfortable margin. For 1998 the estimates showed a budget surplus. Given the weak labour market, the Government proposed a number of measures in the Spring Budget Bill to reduce unemployment, among them increased subsidies to local and county governments, an increased number of student places, and environmental undertakings. With these measures, it was estimated that the budget would be mostly in balance. The gross public debt was estimated to shrink to 77 per cent of GDP.

In the Spring Budget Bill of 1997, the targets for public finances for the years after 1998 were presented. The Government proposed a long-term goal: a surplus in the public finances of 2 per cent of GDP on average over a business cycle. For 1999 the target has been set at 0.5 per cent of GDP and for the year 2000 at 1.5 per cent. Thereafter a long-term goal of a 2 per cent surplus will be reached. If cyclical trends indicate a substantially lower than estimated growth, then the fiscal balance will be allowed to weaken. Conversely, if cyclical trends indicate that growth will be significantly higher, then a bigger surplus will be required.

The September 1997 Review

The most recent review, made in connection with the Budget Bill for 1998, showed that the Swedish economy is in a recovery, which will strengthen further during 1998. The rate of inflation has increased in the course of the year, but remains under the Riksbank's objective of 2 per cent. The interest rate level and the exchange rate have stabilised after some unrest in the spring. The improvement in public finances has been more rapid than estimated. For 1997 a deficit equivalent to 1.9 per cent of GDP is expected. Measured using the accounting principles that apply within the EU, the 1997 deficit is estimated at only 1.6 per cent of GDP. The consolidated gross debt as a share of GDP is continuing to fall. In 1998, it is estimated that the fiscal balance target can be met and still leave room for measures such as raising the family allowance that were proposed in the Budget Bill.

5.1.4 Economic Performance 1994-1998 Compared with the Convergence Programme

Total GDP growth over the two past years has been 1 per cent weaker than the forecast in the convergence programme. The contribution from foreign trade was about what was expected, in spite of the fact that the international recovery of the previous year was not forecast in the convergence programme. However investment in business and residential construction as well as public sector investment were weaker.

The financial position of Swedish households has grown more favourable than what was forecast in the convergence programme, owing to, inter alia, the net of taxes and transfers has made a less negative contribution than expected. Because the savings ratio has been reduced to the estimated size, private consumption has been more expansive. In contrast, public sector consumption has been cut much more than expected: 2.7 per cent, compared with the estimated 1 per cent. The divergence is entirely due to central government consumption, which has declined sharply. The drawdown of local government consumption during 1995 and 1996 was less than expected, despite worsened local government finances.

However, the most marked difference from the convergence programme forecast is with respect to employment. Instead of the estimated 170,000 new jobs between 1994 and 1996, the increase was limited to 36,000, based on an average of the number employed during the year. Total unemployment went up 1.3 percentage points. At the same time the labour market policy measures did not reach the planned level and therefore registered unemployment went up 2 percentage points.

Table 5.1: Key Indicators for the Years 1995, 1996, 1997 and 1998
Annual change in per cent

	1995		1996		1997		1998	
	CP	Actual	CP	Actual	CP	Forecast	CP	Forecast
GDP	2.5	3.6	2.9	1.1	2.16	2.3	2.3	3.1
-Private consumption	-0.5	0.8	1.0	1.5	2.2	2.3	2.2	2.5
-Public consumption	-0.2	-1.0	-0.8	-1.7	-1.1	-1.1	-1.0	0.5
- Investments	11.1	10.9	9.6	4.7	7.4	0.4	7.0	5.8
- Exports	10.6	12.6	7.3	5.6	6.5	9.6	5.9	7.2
- Imports	7.5	10.3	6.0	3.5	6.6	8.5	6.8	7.0
Unemployment	7.0		6.1		5.8		5.6	
Government fiscal balance[1]	-9.0	-7.9	-5.2	-2.5	-3.5	-1.9	-0.9	0.6
Gross public debt[1]	84.3	78.2	84.8	77.8	84.0	77.1	81.3	73.9

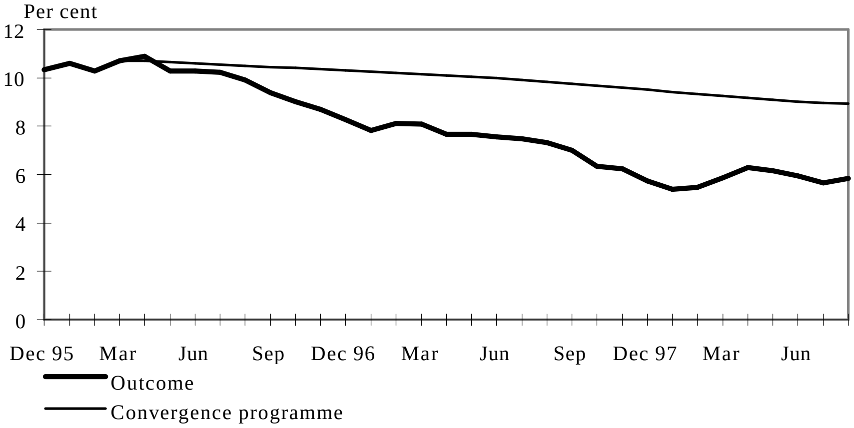
[1] Per cent of GDP,
Source: Ministry of Finance

The financial position of the Swedish economy has grown stronger than what was forecast in the convergence programme. After the unrest that characterised the foreign exchange market when the programme was presented, the krona strengthened markedly in the last part of 1995; a strengthening that continued through 1996. In the convergence programme it was anticipated that the krona would rise about 2.5 percent through 1997. Currently the krona is estimated to have strengthened by more than 6 per cent.

The stronger krona has been accompanied by falling long-term interest rates. The interest rate on five-year government bonds this year is expected to remain more than 3 percentage points lower than what was estimated in the convergence programme. This difference can be partly attributed to lower international rates, but the differential with Germany has also been reduced more than expected.

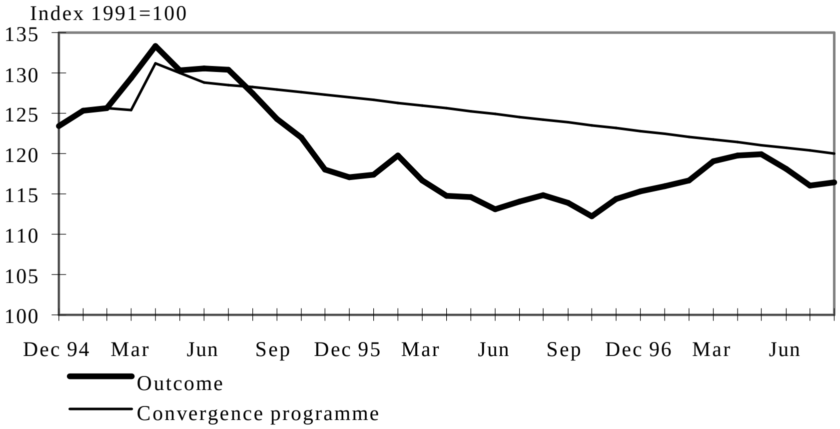
The interest and exchange rate developments have contributed to the marked decline in the rate of inflation. During 1996 the general price level even decreased by 0.2 percentage points. Sweden is expected to have a rate of inflation below 2 per cent this year and next.

Diagram 5.1 Interest rate on five-year government bonds



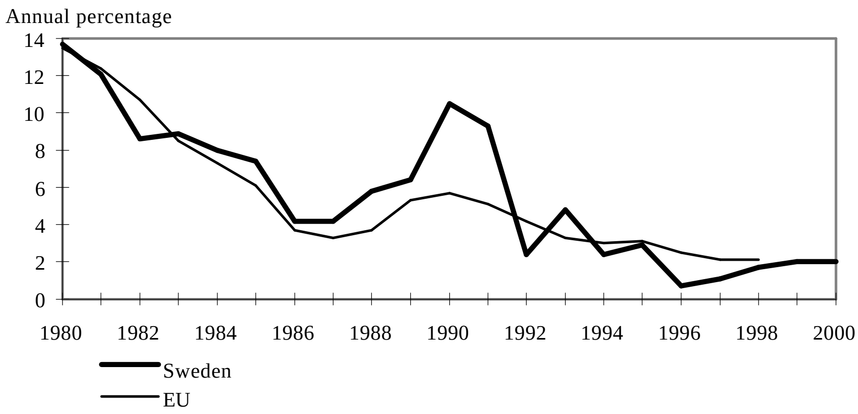
Source: The Riksbank and Ministry of Finance

Diagram 5.2. ECU Index



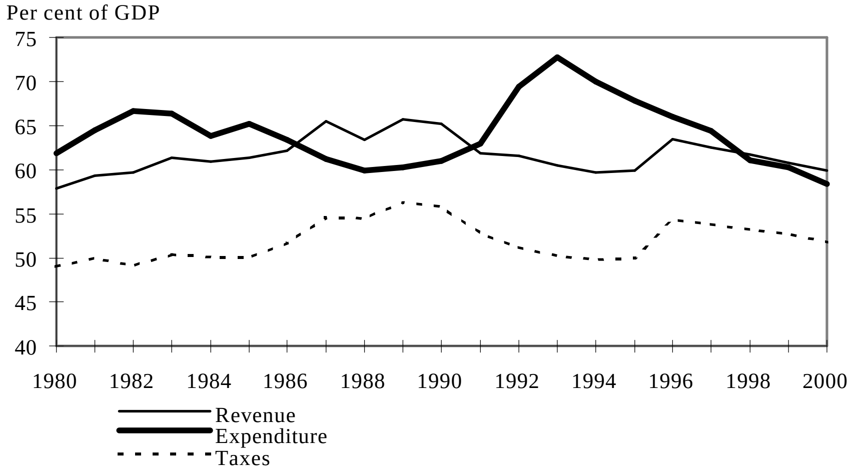
Source: The Riksbank and Ministry of Finance

Diagram 5.3 CPI in Sweden and the EU



Source: OECD, Statistics Sweden and Ministry of Finance

Diagram 5.4 Public Sector Revenue and Expenditure



Source: Statistics Sweden, NIER and Ministry of Finance

5.2 Practical Preparations for the Euro in Sweden

Practical preparations for the start of stage three of EMU in 1999 were begun in the Government Offices and the Riksbank in 1996. The aim of the preparatory work has been to give Sweden a realistic chance to complete the preparations that are needed if it joins the monetary union from the start. Even if Sweden does not participate in the monetary union from the start, certain measures need to be taken and some preparatory work performed owing to the formation of the monetary union. The work on the practical preparations in Sweden will therefore continue. This is also important in order for Sweden to be able to maintain freedom of action and a preparedness to act. The Government is hereby reporting for the Riksdag’s information the situation as it applies to the practical preparatory work. Concrete proposals will be submitted at a later date to the extent that they need the Riksdag’s consideration.

5.2.1 Background

In August 1996 the Government decided that a co-ordination function would be initiated in the Ministry of Finance. Five working groups with the task of working on the practical preparations for the possible introduction of the euro to Sweden were to be set up. In the work, both alternatives – participation in the monetary union from the start in January 1999 and non-participation – were to be analysed. In addition the practical preparations would be performed in a way that would not circumscribe Sweden’s possibility of remaining outside the monetary union.

The working groups have studied the areas of legislation, the financial sector, business sector, public administration and matters affecting individuals. Two reports have been presented in 1997 (Ds 1997:9 and Ds 1997:59). These reports are intended as a basis for taking a position on relevant questions and for the practical planning of the preparations for the start of the monetary union, irrespective of whether or not Sweden participates. It is pointed out that the monetary union signifies that measures are needed in both the private and the public sector. Even if Sweden does not participate from the start in 1999, services in euros will be demanded at that time, most likely in the financial sector and in big companies in the business sector.

A summary of the work in the different areas is given below.

5.2.2 Legislation

As part of Swedish preparatory work in the area of legislation, an inventory has been made of those laws and other regulations that need to be changed in order for the euro to be introduced into Sweden and, alternatively, those that need to be changed if Sweden does not join the monetary union. The inventory comprises technical as well as more substantial changes. The result of the technical inventory can be found in an appendix to Ds 1997:9.

From the point in time when the monetary union is formed, the statutes containing references to the ecu will be changed. If Sweden does participate in the monetary union from 1999, the changes in references to the krona, öre, etc. should be made from the start of the second phase when notes and coins denominated in krona will begin to be replaced by notes and currency denominated in euros, that is, January 1, 2002, at the latest.

The legal framework for the transition to a common currency, the euro, at the Community level is laid down in two Council regulations (section 4.7).

The provisions on the continuity of contracts, that is, the continued validity of existing contracts at the time of the transition to the euro, will be laid down in one of these regulations. Therefore no special legislation is deemed to be necessary in Sweden. To sum up, a transition to the euro will not constitute grounds for annulment or re-negotiation of the majority of contracts. For certain contracts swings in the exchange rate have an important significance. Special legislation for such contracts is also deemed to be unnecessary. Instead any dispute would have to be settled by customary interpretations of agreements or the application of other general principles of legal agreements.

The law (1983:1092) on the statutes for the National Insurance Pension Fund (the First to the Third Fund Boards) permits bonds, promissory notes, and obligations to be denominated in a foreign currency. For each Board the total value of such securities may amount at most to 10 per cent of the total market value of the assets that the Board administers. Participation in the monetary union would lead to a change in this condition in that the euro will not be a foreign currency. Even if Sweden does not participate in the monetary union from the start in 1999, this condition will be changed to a certain extent because the euro will probably have a special status. This is one of the reasons for the work that is in progress in the Ministry of Finance to revise the investment rules of the National Insurance Pension Fund. A draft report is expected to be ready for presentation in autumn 1997.

If Sweden does not join the monetary union at the start in 1999, the question emerges of how long a preparation time is required, inter alia, to adjust Swedish legislation before a possible entry later. The inventory of the statutes, which has been conducted in the Government Offices, showed that a large number of changes of a more technical nature must be made. The most extensive amendment required is to change the words kronor and öre to euro and cent and to convert all the amounts stated in Swedish currency to an even value stated in euros and cents.

With respect to legal questions of a more complicated nature, it may be necessary that statutory amendments be preceded by some form of inquiry and referrals for comments. The time required for this would probably exceed one year. A large number of the statutes containing sums of money are regulations. Such statutes can be changed in a short time.

5.2.3 Public Administration

When taking stock of the problems in the public sector, the focus has been on two questions: what time intervals should apply for the different steps in the adjustment process and what obligation will public organisations have with respect to adjusting their work to other interested parties' wishes concerning choice of currency during the transition period.

One principle that earlier was prevalent in many EU countries was that during the transition period the public sector would keep on using the national unit of currency until the notes and coins denominated in euros came into circulation. This principle meant a late transition for the public sector. However in some countries the possibility is now being examined of conducting some communications with the public sector in euros during the transition period. It primarily concerns the opportunity for firms to use euros in their annual reports and state equity capital and make tax declarations in euros. A number of countries, among them Belgium, France, The Netherlands, Finland, Ireland and Luxembourg are giving some consideration to preparing the public sector for the use of two currencies for certain tasks during the transition period. As to internal transactions in the public sector, such as budgeting, accounting, etc., the aim, without exception, is to use the national currency until January 1, 2002.

The adjustments to the EDP system in the public sector, as in business, will be important. A transition to the euro will require extensive changes in the authorities' data processing. As to EDP systems, which constitute a means of production in various activities and in all communications to and from the authorities connected to EDP systems, the adjustment problem will be substantially more extensive than in the accounting systems. Generally, adjusting the EDP system will be a bigger problem if Sweden joins the monetary union on January 1, 1999 than if it joins at a later time. A later entry would mean that the time pressure to make the necessary changes mentioned by many authorities would not be so burdensome. Joining later would also relieve the resource conflicts with the ongoing IT switch-over by the year 2000.

5.2.4 Tax Issues

The *tax issues* raised by EMU refer primarily to the taxation of foreign exchange earnings. For *private persons* – according to the applicable law – foreign exchange profits are taxed when they are realised. Likewise foreign exchange losses are deductible when they are realised. If Sweden does not join the monetary union, those Swedish persons who have assets in EMU currencies will have a ”forced conversion” to the euro. The natural solution is not to contemplate this conversion as a sale. This solution results in foreign exchange profits – in conformity with what applies today – being taxed (and foreign exchange losses deducted) when the asset is sold (or the liability is paid). For other assets the tax consequences of entry occur when the assets are sold or written off.

In the case of companies the value of claims and liabilities denominated in foreign currencies is estimated on the rate of the accounting date (i.e. the exchange rate profits and losses are taxed day-to-day). If such a valuation is not compatible with good accounting practice, the posting of the item will follow good accounting practice. In this case the company will be imposed a tax for a standard revenue amounting to 54 per cent of the interest on central government debt times the difference between the value according to the rate of the accounting date and the book value. For other assets the tax consequences will be imposed when the asset is sold and written off, respectively.

5.2.5 The Financial Sector

EMI is making preparations for a common European payments system, TARGET. Its most important function will be to make possible the execution of common monetary policy. In addition banks and their customers can use TARGET to make payments in euros. TARGET will be built on the existing national clearing/interbank payments systems, in Sweden’s case, the Riksbank’s RIX system. Joining the monetary union would mean that the Riksbank would only need to effect some minor changes in this system. However along with these changes, work will be needed to create a link that will make it possible for RIX to communicate with equivalent systems in other countries.

If Sweden does not participate in the monetary union from the start, the possibility still exists to participate in TARGET for payments in euros. However it is possible that the terms for using TARGET will be less favourable in that case. With non-participation the Riksbank must in addition create a euro function in RIX and administer two parallel systems, which leads to more work.

In principle the banks themselves, like all the private sector, will choose how and at what point in time during the transition period one will switch over to the euro. However certain rules will apply to banks. The EC legislation which regulates the transition to the euro enjoins the banks to have a convergence mechanism for account holders. This will be important in making the transition easier for other players. The technical solution that is planned means that every bank must maintain kronor-euro conversion facilities in connection with its own system. This method is intended to be combined with the so called original currency model. This means that the payer chooses in which currency the payment will be made to the payee.

With respect to the banks' activities in the retail market, the transition to the euro will probably be made relatively late in the process because the coupling of the these activities to the exchange of notes and coins during the first half of the year 2002 at the latest is relatively firm. The transition with respect to the banks' activities in relation to companies will probably be made at an earlier point in time. Especially larger, internationally active companies will quickly venture to make large-scale transactions in euros and the euro in many cases will most likely become the currency of large groups of companies. Retail trade and other consumer-oriented activities will probably come later in the process, but these, too, will come to have need to make use of the euro before 2002, for example, in short-term payments.

The possibility of making payments in euros will very likely be in demand even if Sweden does not join the monetary union. How far-reaching the demand will be and how it will develop over time are, however, most difficult to judge. In part it will be decided by whether non-participation is judged to be of short or long duration or to be permanent. If Sweden is expected to enter relatively soon, the requirements for handling payments in euros are judged to be relatively large. To build and use parallel systems for kronor and euros obviously implies higher costs.

The question of how long time the banking system will need in order to prepare itself in the event that Sweden does not participate in the monetary union at its inception but then after a while decides to join is the subject of a study by the banks. A preliminary assessment indicates that the probable lead time is about two years from the time that it becomes clear that Sweden will participate until notes and coins denominated in euros can be introduced.

If Sweden participates in the monetary union from the start, institutions in the securities market have decided to implement the transition in the form of a ”big bang”. This means an immediate transition from Swedish kronor to euros on January 1, 1999 as the trading currency for the financial instruments that will be traded on the Stockholm stock exchange and as settlements currency by the

Securities Register Centre. The same applies to money market instruments.

If Sweden does not join the monetary union from the start, commercial transactions will continue to be predominantly in Swedish kronor. At the same time there will probably be a growing amount of securities that will be issued and traded in euros. However the extent of the latter is difficult to assess.

Redenomination of Debts and New Public Borrowing in Euros

The legislation that regulates the introduction of the euro will give Member States the right to take measures to redenominate public debt in the euro currency unit. The condition for this is that the debt is stated in the national currency of the Member State and has been issued in accordance with its own legislation. Redenomination itself does not impose a requirement for new legislation; instead it could be accomplished by a change in the instruction for the National Debt Office or by a direction in the annual budget instruction from the Government to the Office. However whether legislation should nevertheless be used is a matter which should be further considered before a possible Swedish participation in the monetary union.

In the event that Sweden remains outside the monetary union when it is formed on January 1, 1999, new domestic public borrowing will continue to be denominated in kronor. There will be no need at that time to give the issuer the unilateral right to convert outstanding debts denominated in kronor. The conversion of public and private debt issued by Swedish lenders in a currency that will be replaced by euros, according to EC legislation referred to previously, will be made when the participating Member State concerned has converted some part of its public debt, assuming that the debt is issued under the law of that country.

5.2.6 The Business Sector

The monetary union will affect business operations considerably, irrespective of whether or not Sweden participates from the start. Some companies intend to use the euro in either event. With a common currency the single market will become more transparent, an outcome that will affect the companies' competitive position, price setting, etc. In a study, the Swedish National Board for Industrial and Technical Development has analysed the effects on production and employment of Swedish participation and non-participation in the monetary union respectively. In addition companies' price-setting behaviour in case of fluctuations in the exchange rate and the possible consequences of increased price transparency have been analysed.

The business sector is presumed to plan and implement the necessary measures independently and at their own expense. With participation in the monetary union and the transition to the euro, the measures on the Government's side in relation to business, as far as can be judged now, will be limited. However certain adjustments of the legislation that pertains to trade and commerce will be necessary.

In the event of Swedish membership in the monetary union in 1999, Swedish joint-stock companies would by January 2002, at the latest, be forced to state their equity capital in euros. Interest has been expressed on the part of companies in being able to state equity capital in euros during the transitional phase after January 1, 1999. Some Swedish companies that are active internationally have expressed the wish to state equity capital in euros even if Sweden does not participate in the monetary union.

In spring 1997 the Government instructed a special investigator to assess what was required in order for companies, banks, and insurance companies to state equity capital and nominal share values in currencies other than the Swedish krona. The investigation has in view both what may need to be done during the transition phase, which will extend from January 1, 1999 to the end of the year 2001 if Sweden participates in the Economic and monetary union from the beginning in 1999 and what could be required if Sweden does not join. The results of this work will be reported in autumn 1997.

Also on the matter of companies' accounting practices, the establishment of the monetary union may raise a legislative question. This concerns the extent to which Swedish companies will have the opportunity to use the euro in their external accounting. Participation in the monetary union from the start in 1999 means that the accounting must be done in euros beginning in the year 2002. Unless the legislation is changed, the accounting during the transition phase must be done in Swedish kronor. Companies have expressed the wish to be allowed to use the euro as the unit of account during the transition phase. They have also expressed the desire to be able to keep their accounts in euros even if Sweden does not participate in the monetary union.

The special investigator who has been assigned by the Government to investigate the question of equity capital denominated in euros has also been given the task of researching the corresponding question of what requirements Swedish companies have in order to be able to institute financial accounting in euros.

5.2.7 The Euro and the Citizen

The general public can be expected to come into contact with the euro even if Sweden does not join the monetary union. For example, some part of the retail trade in larger cities and popular tourist venues will venture to give prices in euros. Private persons' savings and investments in European currencies will also be influenced by the monetary union.

If Sweden does participate in the monetary union the changes will naturally enough be more pronounced. In that case the positive effects on citizens are expected to consist of a reduction in the cost of exchanging currencies, a greater possibility of comparing prices, with probably lower prices on goods and services as a consequence, and to a certain extent improved opportunities to borrow.

If Sweden does not join the monetary union from the start in January 1999 the general public still needs to be given information. By joining the monetary union later it can benefit from the experience of other countries.

If Sweden were to enter the monetary union after the start on January 1, 1999, there is still the question of how long the necessary preparation time should be. For the citizens' and consumers' part, it is not only measures to provide information that are important to take into consideration. The general public must be informed about the EMU process in detail as well as the more practical consequences of the introduction of a new currency, with new notes and coins. Those with special needs, such as older people, the sight and hearing impaired, and others, must naturally be taken into consideration. Should Sweden decide to participate, the time required for preparation for the introduction of notes and coins denominated in euros, as indicated in the preceding discussion, is expected to be about a year.

5.2.8 Continued work

Even if Sweden does not participate in the monetary union from the start on January 1, 1999, certain measures will need to be taken, as noted previously, and some preparatory work done as a consequence of the formation of the monetary union and the introduction of the euro in a number of EU countries. To sum up, it is a matter of, inter alia, identifying and analysing requests and requirements for changes in laws and changes in regulations that are directed at the public sector. By way of example, as mentioned earlier, the wish of the business community to be able to do their annual reports in euros and state equity capital in euros is already under analysis in the government offices. In addition it should be noted that there is a need for information on the consequences for Swedish companies, banks and private persons in the event that Sweden does not participate in the monetary union from the start on January 1, 1999. It is also important to follow developments with reference to preparatory work and the transition in those countries that will participate in the monetary union from the start. Certain technical changes in national regulations and the like will also need to be effected as a result of the formation of the monetary union.

In order to maintain freedom of action, it is also important to examine more closely how long a preparation time is required in different areas prior to a possible later entry. The nature of the necessary preparatory work and thereby the length of the transition period differs from area to area. A preliminary assessment indicates that the probable lead time is about two years from the time when a political decision on participation is taken to the time when notes and coins in euros can be introduced.

Against this background, the Government intends to continue the work on the practical preparations for the introduction of the euro.

6 Sweden's Economic Policy outside The Monetary Union

The Government's assessment and proposal: The demands on economic policy will not lessen if Sweden stays outside the monetary union. It will be at least as important to pursue a stability oriented economic policy. Outside the monetary union Sweden will have to demonstrate at least as clearly its efforts both to maintain stable prices and to establish a long-term surplus in the public finances.

6.1 Background

In this chapter the Government expresses its view on what will be required of economic policy should Sweden stay outside the monetary union.

To begin with, it is important to establish that Sweden's economic policy is formulated in an international environment, irrespective of whether or not Sweden participates in the monetary union. The continuation of European integration will also affect Sweden as a non-participating Member State. The Swedish economic policy deliberations will, in any event, need to be affected by the increasing integration on account of the development of the single market, including the strengthened impetus to a single financial market.

The overriding goal must be to ensure that Sweden has the best possible economic development outside the monetary union. The demands on economic policy do not lessen if Sweden stays outside the monetary union. It would be devastating if Sweden were to return to a pattern of high inflation, weak public finances and a trend to a weakening currency.

Sweden's economic policy is aimed at increasing employment and decreasing unemployment. The goal to cut registered unemployment to half the 1994 level by the year 2000 remains unchanged. The prospects for combating unemployment, in the Government's view, do not differ to any great extent between the alternatives of participation and non-participation in the monetary union.

The start of the third stage does not imply any change in decision-making competence as regards fiscal or structural policies of the Member States. However for monetary and exchange rate policy the difference between participation and non-participation is significant in this respect. Non-participating Member States retain the power to decide their monetary and exchange rate policy, whereas participating Member States transfer their powers in these areas to the Community. However as noted in chapter 4, the start of stage three means some changes for non-participating members also. These changes concern, inter alia, the Stability and Growth Pact and exchange rate policy.

Certain general rules on economic policy in the EC Treaty apply to both participating and non-participating Member States. In Article 3a(3) the guiding principles of stable prices, sound public finances and monetary conditions and a stable balance of payments are stated. In the Government's view these principles express what should be guiding for a sound and strong economy. It should also be remembered here that the Treaty emphasises that Member States shall co-operate on economic policy and regard it as a matter of common concern.

6.2 Fiscal Policy

It was the view of the Government Commission on EMU that there was hardly any difference in the long-term demands on fiscal policy between the alternatives of participation and non-participation in the monetary union. Growing public indebtedness is unacceptable in any exchange rate regime. However in the short term the alternatives differ markedly. The Government Commission on EMU had the opinion that outside the monetary union an expansive fiscal policy with large budget deficits could trigger currency depreciations and rises in the long-term interest rate level throughout the economy owing to increased inflationary expectations. The Government Commission on EMU was of the view that the budget consolidation requirement would mean that fiscal policy measures that would increase the budget deficit would hardly be possible. The Commission could only make limited comments on the effects of the Stability and Growth Pact since it had not been completed when the Government Commission on EMU presented its report.

The organisations to which the proposal to participate in the monetary union has been referred for comment have only made limited comments on the matter of fiscal policy in the event that Sweden does not join the monetary union. They have not objected to the Government Commission on EMU's reasoning**.** The Swedish Trade Union Confederation emphasises the importance of fiscal policy regulations not being allowed to prevent automatic stabilisers from working.

The Government is of the view that sound public finances are necessary outside as well as inside the monetary union. They are at least as important outside the monetary union.

Public finances in Sweden have improved at a rate that has no international precedence. Ambitious goals for public finances have been firmly established by the Government and the Riksdag. The goals will also be achieved. After 1998 there will be a surplus in the general government financial balance, equivalent to 0.5 per cent of GDP in 1999 and 1.5 per cent in the year 2000. The surplus will be equivalent in the long term to 2 per cent of GDP on average over the economic cycle. This objective applies from the year 2001.

The reformed budget process is important in being able to maintain sound public finances on a sustainable basis. The new budget process with an annual ceiling on total expenditure means that in practice it is not possible to propose unfinanced expenditures during the course of the fiscal year.

Outside the monetary union Sweden will also be subject to the rules in the Stability and Growth Pact, but the strongest measures in the form of giving of notice and sanctions will not apply. It is good for growth and employment in the EU as a whole that there are rules that can effectively contribute to strong public finances in the Member States.

At the same time it is important that the rules in the Pact have a sufficient degree of flexibility. It is the view of the Government that this is the case. The ambitious objectives for public finances that Sweden has set provide a satisfactory safety margin to the reference value for the deficit. Recessions and other types of shocks in the economy can be counteracted by automatic stabilisers.

All in all the Government is of the opinion that if Sweden stays outside the monetary union, it will become at least as important to hold steadfast to the goals for the public finances.

6.3 Monetary Policy

The Government Commission on EMU was of the view that the possibility of conducting a national monetary policy represented a significant stabilisation policy advantage and that therefore Sweden should remain outside the monetary union when it is started. This national monetary policy would be able to function as a sort of insurance against macroeconomic shocks, which would affect Sweden differently than Member States in the monetary union. Such insurance is especially valuable during a period like the current one of high unemployment and little room for manoeuvre in fiscal policy. According to the Government Commission on EMU, this is one of the principal reasons why Sweden should not participate in the monetary union from the start. In addition it was the opinion of the Government Commission on EMU that unemployment should be combated with a series of structural policy measures, especially with respect to the labour market, together with a demand stimulating monetary policy. This could, according to the Government Commission on EMU, be done without the inflation target being threatened. However there was a risk that monetary policy might experience a serious credibility problem, that would lead to a weakening of the krona and higher long-term interest rates, if Sweden chose to remain outside the monetary union. Therefore the Government Commission on EMU recommended a reform of the Riksbank to strengthen its independence and thereby increase credibility in the price stability policy.

Those bodies to which the Government Commission on EMU's report had been referred for comment responded in many cases with the view that the Government Commission on EMU exaggerated the actual monetary policy freedom outside the monetary union and the importance of having access to an independent monetary policy. The Riksbank questioned that the Swedish economy would be particularly exposed to asymmetric shocks. It was the Riksbank's view that there was an apparent risk that the inflation target would not be perceived as credible if a Swedish decision to remain outside the monetary union were to be based on the argument that monetary policy is needed to counteract macroeconomic shocks. In addition the suggestion that an independent monetary policy should be used as a means to combat unemployment was criticised. The Swedish Trade Union Confederation pointed out that internationalisation also sharply limits national freedom of action outside EMU.

The Government wishes to emphasise that price stability is a prerequisite for a successful economic policy. This statement is valid both inside and outside the monetary union. The principal task of monetary policy is price stability. The Riksbank conducts monetary policy independently and the Governing Board of the Riksbank has defined the inflation target as follows: the increase in the consumer price index will be limited to 2 per cent, with a tolerance interval of plus/minus 1 percentage point. The Government supports the thrust of monetary policy and stands behind the Riksbank's inflation target.

The five-party agreement mentioned in section 4.5 on the status of the Riksbank has been made with the aim of reinforcing credibility in Swedish monetary and exchange rate policy. In addition Sweden has, as a consequence of its EU membership, undertaken to strengthen the independence of the Riksbank. In the five-party agreement, a price stability objective for the Riksbank prescribed by law is included.

The Government notes, like the Government Commission on EMU, that the Riksbank can only support the general economic policy to the extent that that it is possible without the price stability objective being threatened. A national monetary policy can thereby only be used to stimulate demand if the situation in the labour market, or elsewhere in the economy, is such that this can be accomplished without confidence in the monetary policy diminishing.

With reference to the Government Commission on EMU's reasoning on the importance of being able to conduct a national monetary policy to counteract individual and, for Sweden, specific economic shocks, it is the Government's opinion that the merits of this possibility must be weighed against the risks to confidence in monetary policy that it would entail, something that also the Riksbank states in its opinion. In the Government's view, it is not obvious that the value of conducting a national monetary policy balances these risks.

6.4 Exchange Rate Policy

The Government Commission on EMU was sceptical of a new ERM arrangement. It was the Government Commission on EMU's view that a system with floating exchange rates and a common inflation target was preferable. The Government Commission on EMU judged participation in a new ERM to be a significant risk-taking, inter alia, given the exchange rate turbulence during 1992 and 1993. It felt that those Member States outside the monetary union which were participating in the ERM 2 would have to make most of the adjustments. It would be better for Sweden, in the Government Commission on EMU’s view, to keep its current monetary policy strategy of a floating exchange rate and an inflation target. In addition to the reasons against Swedish participation in the ERM 2 already given, Sweden’s history of repetitive devaluations would probably mean that an exchange rate target for the krona would no longer be effective as a means of creating credibility. However the Government Commission on EMU thought that there were political costs associated with staying outside the exchange rate system. It saw a possibility of narrow fluctuation bands as a big disadvantage in the new ERM. When the Government Commission on EMU’s report was presented the negotiations leading to the agreement on the ERM 2 had not been concluded.

Of the relatively few organisations commenting on this matter, the majority favoured participation in the ERM 2. Among them were the National Debt Office, the Swedish Employers' Confederation and the National Institute of Economic Research. The National Agency for Government Employers and the Swedish National Board for Industrial and Technical Development agreed with the view of the Government Commission on EMU. The Riksbank did not comment on this matter.

Earlier in section 4.6 *the Government* has reviewed the ERM 2 and the regulations and conditions that apply to exchange rate policy in Member States outside the euro area.

It should be noted here that according to the five-party agreement on the status of the Riksbank, it is the Government that will decide the exchange rate system. The Riksbank will decide the central rate and the fluctuation band in a system of fixed exchange rates and the practical implementation of a floating exchange rate.

The Government wants to emphasise that there is no legal obligation to participate in the present ERM. Nor will there be any such obligation with respect to the ERM 2. Participation will be voluntary. Nevertheless, Member States with a derogation can be expected to join the mechanism. Sweden’s membership in the EU means that Sweden, like other Member States, will, in accordance with Article 109m, treat its exchange rate policy as a matter of common interest. Sweden does fulfil this general commitment through its current monetary policy regime of an inflation target and a floating exchange rate within the framework of a stability oriented economic policy. Another way to fulfil this general commitment would be participation in the ERM or the ERM 2.

The economic policy of Member States outside the monetary union will, as mentioned in section 4.6 be the subject of surveillance in accordance with Article 103, with the aim of avoiding real exchange rate misalignments and excessive fluctuations in the nominal exchange rate between the euro and other EU currencies that can threaten the single market. In addition the Commission will monitor exchange rate developments and the Economic and Financial Committee will follow the monetary situation in Member States with a derogation.

It is reasonable that the Community will follow monetary developments and monitor economic policy to see if it is oriented towards stability and thus suports stable exchange rates. Monetary stability is important for the good functioning of the single market.

It is the Government's view that it is not the time for participation in the ERM. Experience has shown that the current policy aimed at price stability in combination with an exchange rate regime with floating exchange rates works well.

There are economic reasons for not participating in ERM2, which the Government Commission on EMU has underlined. Among them, Sweden, in recent years, has had a negative experience with different fixed rate arrangements. However, part of the negative assessment of the ERM 2 by the Government Commission on EMU was based on the misgiving that the fluctuation bands would be narrow or would gradually narrow later. With the design of ERM 2 now completed, that misgiving should not be so great.

Participation in the ERM 2 can be seen as a direct preparatory step before entry into the monetary union. Therefore, many arguments speak in favour of bringing the krona into ERM 2 only in connection with a possible future Swedish participation in the monetary union.

7 Considerations on Sweden and EMU

The Government's proposal: Sweden should not introduce the European Union's single currency, the euro, when the third stage of Economic and Monetary Union starts on January 1, 1999. Sweden should keep the door open for a later Swedish participation in the monetary union. The greatest possible freedom of action should be preserved. If the Government later finds that Sweden should participate, it will submit the question to the Swedish people for consideration.

7.1 The Issue of Swedish Participation in The Monetary Union When It Is Established at the Start of Stage Three

The issue of participation in the monetary union is one of the most important political issues. EMU is the largest project in European integration since the Treaty of Rome. Both alternatives of participation and non-participation mean changes compared to the existing situation. The Government has worked for a long time on national preparations and negotiations in the EU and has stimulated analysis and debate. The matter has been examined in depth.

The Government's view throughout has been that the position on the single currency shall be taken from a position of strength. This means that Sweden's economy must show a sufficient degree of strength and sustainable stability. It is also necessary to have progressed far enough in national practical preparations of a legal nature and other preparations. The Government has consistently held that the Swedish decision must have a strong democratic basis.

Sweden's economy has experienced the deepest recession since the 1930s. Only a few years ago Sweden belonged to that group of countries in the OECD that had the worst deficits in public finances. GDP decreased for three years in a row, investments fell and unemployment rose sharply. Sweden has a history of high inflation. In 1991, before the recession set in, the Swedish consumer price increase was approximately double the average for the EU. When the economic crisis was at its worst, there were few who believed that the Swedish economy would be able to achieve such strength that it would be able to meet the terms of entry for the monetary union. Since that crisis the Swedish economy has undergone extensive consolidation. All in all it is the Government's view that Sweden's economy has achieved a sufficient degree of strength and sustainable stability to be able to participate in the monetary union. The Government does not share the conclusion of the analysis done by the Commission on EMU, according to which the reason that Sweden should wait before participating in the monetary union is that the economy needs more time to reach a sufficient degree of stability with respect to its public finances and unemployment. Sweden's economy has improved substantially in the past year and compares favourably with other countries' economies.

The situation of national practical preparations was described in section 5.2. Extensive work needs to be done in both the private and the public sectors in order for it to be practically possible to introduce the euro. The Government considers it important that the preparations begin in good time. Thus the Government contributes to ensuring that the preparations are made with sufficient advance planning.

Participation in the monetary union must have a strong democratic basis. EMU is to a large extent a political project. Participation should be seen as an expression of the political will to bring about a substantial deepening of European integration. There is not public support for joining the monetary union when it is established January 1, 1999. Opinion polls and many other indicators clearly show this to be the case.

There is not any simple explanation for the Swedish people's wait-and-see attitude. Conditions that are not directly linked to EMU may play a role. At present in Sweden there are negative attitudes towards the EU. Some who voted in favour of EU membership probably believed that it would affect their daily lives more swiftly and positively. The necessary budget consolidation may as well have affected peoples' attitudes towards the monetary union, although the budget consolidation would have needed to be equally as extensive without EMU.

While the attitude of the general public is negative, business, organisations and authorities are more positive. This is evident from the responses to referrals for comment on the Government Commission on EMU. Nearly half of those who replied thought that Sweden should participate right from the start of stage three and a considerably smaller number concurred with the recommendation of the EMU Commission that Sweden should wait and see. A third of the respondents chose not to take a position on the question of whether Sweden should participate. A small number of the respondents rejected any Swedish participation at all.

However the negative attitudes of the Swedish people must be decisive for the Government's position. The credibility of Sweden's political system would strongly risk being called into question if the Riksdag decided on the major step of joining the monetary union from the start. At the same time the EU and the Swedish membership in the EU would be called into question even more. It is in the interest neither of Sweden nor of Europe to try to drive through Swedish participation in the monetary union from the start when there is not broad enough public support for it. It would risk creating a division. Sweden would not be able to make a positive enough contribution to the formation of EMU if the participation were not underpinned by public support.

When a position is taken on the issue of participation from the start, two other important factors also need to be considered.

The first factor is whether Sweden's economy would be damaged if Sweden remains outside the monetary union from the start. This could happen if participation would bring important economic benefits that Sweden would have to forgo if it remained outside the monetary union. This could also happen if the situation as a non participating Member State in itself led to negative effects. It was the opinion of the Government Commission on EMU that participation in the monetary union would give certain, but fairly small economic efficiency gains. It was also the Commission's view that outside the monetary union, Sweden would have more difficulty effecting credibility in its economic policy. However the Commission was of the view that it was possible to take measures to compensate for this. The Government largely shares the assessment on the economic efficiency gains. As mentioned in Chapter 6, it is the Government's assessment that it is possible to achieve credibility in the economic policy also outside the monetary union.

A second factor to consider concerns Sweden's opportunities to exert influence in the EU as a consequence of a Swedish decision not to participate in the monetary union. It was the opinion of the Commission on EMU that the effects of remaining outside are negative in this respect. The Government shares the assessment that Sweden's influence would be greater if Sweden joined the group of countries that will deepen European integration by introducing the single currency. However it is the Government's assessment that this aspect should not have greater weight than the lack of public support.

When the Council examines which Member States fulfil the necessary conditions for participation in the monetary union, it will take into account the convergence criterion on exchange rate stability. The interpretation of this criterion today appears uncertain. The Government has maintained that the basis for interpreting this criterion has changed. When the Treaty was written, the normal fluctuation bands in ERM were plus/minus 2.25 per cent. The Treaty mentions two years before the review as the time required to have observed the normal fluctuation bands of the exchange rate mechanism of the European Monetary System without devaluing against the currency of any other Member State. On August 1, 1993, the fluctuation bands were expanded to the widths that apply today of plus/minus 15 per cent. Against this background, the relevance of this criterion can be called into question. However it appears that the Commission and most Member States are of the opinion that participation in ERM (or ERM 2) is necessary before entering into the monetary union.

If the Riksdag approves the Government's proposal and adopts as its opinion that Sweden should not introduce the euro, the single currency of the European Union, when stage three of EMU starts, the Government, represented by the Minister of Finance and the Prime Minister, will act in accordance with this opinion when the Council makes its examination according to Article 109j(4) in spring 1998.

7.2 Future Participation in The Monetary Union

If a Member State does not participate in the monetary union from the start, it has the right to participate at any later date, provided that, in the Council’s view, it fulfils the necessary conditions. Sweden should keep the door open for a later Swedish entry. It should maintain the greatest possible freedom of action and preparedness for the future, not least by preserving the economic position of strength that has been achieved. Another means of maintaining freedom of action is to continue the work on national practical preparations so that a possible future transition to the euro can be implemented in an appropriate manner.

The EMU issue will most certainly be an actuality for a long time. Debate and analysis are to be expected both in this country and on the European level. The Government will follow and evaluate developments carefully.

After January 1, 1999, the Government, if it finds that Sweden should participate in the monetary union, will submit the question to the Swedish people for consideration. It is desirable that such a consideration is made in a general election, but an extra election or referendum instead cannot altogether be ruled out. Thereafter it is for the Riksdag to take the final decision.

If Sweden decides in this way to participate in the monetary union, a process within the EU will begin. The Commission and the ECB will prepare reports on Sweden. Thereafter the European Parliament will deliver an opinion on Sweden’s participation and the Council in the composition of Heads of State and Government will discuss. Then the ECOFIN Council, acting by a qualified majority, decides to abrogate Sweden’s derogation. A date will need to be set for Sweden’s entry into the monetary union. The ECOFIN Council, by the unanimous decision made by Sweden and participating Member States, determines a rate of conversion between the euro and the Swedish krona. Some time will then be needed between entry into the monetary union and the introduction of notes and coins denominated in euros.

7.3 Aspects of Co-operation

EMU should play a major role in Sweden’s continuing work with respect to the EU, even if Sweden remains outside.

EMU is a very important project for the EU and its Member States. There is a strong political will to realize the monetary union. Sweden has considerable interest in the success of EMU.

Sweden should continue to take a constructive part in the preparations for stage three. We should be active in the discussions. Sweden is potentially affected by the rules of the game for EMU. There is reason for Sweden to continue to exert its influence on such matters. We should continue to analyse the various issues that are related to EMU. When the third stage is begun, it will be very important to study how the EMU functions from different aspects.

At the same time, in our roles in different bodies of the EU, we need to respect that some issues only, or to a great extent, apply to participating Member States. On our side, we have reason to expect EU bodies and other Member States to respect Sweden's situation.

For a relatively small Member State, it is especially important to be highly effective in its work in EU. When Sweden remains outside the monetary union the requirements in this respect increases. It becomes even more important to have good co-ordination and consistency of action to be able to pursue matters of priority such as the enlargement, growth and employment, reform of agricultural policy, the environment and openness. It is also urgent that Sweden continue its active commitment to the work of the EU and to the continuing process of integration.

Outside the monetary union, Sweden will also participate fully in the single market on the same terms as other Member States. Sweden's economy is highly integrated with those of other EU countries. Growth and employment in Sweden will to a great and probably growing extent be dependent on economic developments in the European Union.