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Should Sweden adopt the euro?

Abstract

In his State of the Union Address from September 2017, Commission President Juncker announced that the Commission is willing to require the EU members to join the euro if all convergence criteria are met. Sweden should therefore be prepared to explain whether and why it intends to be in or out. Sweden is clearly doing well outside the Eurozone and adopting the euro would have to be pushed through against the preferences of the public. The Swedes have nothing to win with regard to lower risk premia on government bonds. But they would lose their remaining degree of freedom in setting interest rates and exchange rate policy. Also, if the Eurozone gained a more redistributive capacity, Sweden would clearly find itself in the donor camp. Sweden may enter into negotiations for more exchange rate stability between the krona and the euro, but joining the Eurozone in its current state is not an attractive option for Sweden.

1 The shrinking group of EU members outside the euro

Since 2015 when Lithuania entered the Eurozone, the number of EU members outside the euro has shrunk to nine. Two of them, the UK (which is about to leave the EU entirely) and Denmark, have secured legal exemptions and are definitely not obliged to adopt the euro. The other seven EU members outside the euro are in principle obliged to become parts of the Eurozone when they meet all convergence criteria: Sweden and the six Eastern European EU members Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania.[1]

Sweden could clearly join if it decided to because it meets nearly all the convergence criteria. The only exception is membership of the Exchange Rate Mechanism II. The fact that Sweden cannot be forced into the ERM II against its will implies that in practice, the decision whether or not to keep the krona remains in the hand of the Swedes. In the referendum in 2003, 56.1% of voters decided that Sweden should stay outside the euro area, a decision which all Swedish governments have respected since.

The decision should nevertheless be reviewed from time to time and Sweden has good reasons for doing so now. First, in his State of the Union Address on 13 September 2017, Commission President Jean-Claude Juncker expressed his view that the formal obligation to join the euro should be taken seriously in the near future.[2] Sweden should therefore be prepared to clearly explain whether and why it intends to be in or out. Second, Brexit will rebalance political power inside the EU in favour of the euro members. As long as the UK is a member of the EU, the GDP of the EU members outside the Eurozone equates to about 40% of those in-

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1 The convergence criteria are laid down in article 140 TFEU.

2 "The euro is meant to be the single currency of the European Union as a whole. All but two of our Member States are required and entitled to join the euro once they fulfil the conditions." Source: https://ec.europa.eu/commission/state-union-2017_en.

side the euro. After Brexit, that number will shrink to about 16%.[3] This indicates that the political voice of the non-euro-countries will shrink in EU decision making, and that the non-euro members may become less heard when it comes to euro group decisions that nevertheless affect EU members outside the Eurozone as well.

2 Public opinion is not in favour of replacing the krona

Thanks to the Flash Eurobarometer 453 carried out in April 2017, we have good data on whether the Swedish government is likely to win a euro adoption referendum.[4] Respondents in all seven EU member states that are legally obliged to join the Eurozone if they meet the defined conditions were confronted with a battery of euro-related questions.

According to this survey, 74% of Swedes think that their country is not ready to introduce the euro (question 4b); 55% think that the introduction of the euro would have rather negative or very negative consequences for Sweden as a whole, compared to 36% who think that the effects would be rather or very positive (q10.1). Asked about the likely consequences for their personal life, 44% responded that the effects would be rather or very negative, compared to 42% who think that the consequences would be rather or very positive (q10.2). 62% responded rather or very negatively to the question of whether, in their opinion, Sweden should join, compared to only 35% who rather or very much support the idea of Swedish euro membership (q11). Finally, 51% of the respondents expect Sweden to never join (q4c).

3 Sweden outperforms the Eurozone

Sweden weathered the financial crisis better than the Eurozone and the expectations for the near future are good, too. The Swedish economy grew by 3.8% percent in 2015 and 3.1% in 2016 (Eurozone: 1.9% in 2015, 1.7% in 2016).[5] The OECD expects Swedish growth to remain solid.[6] With an unemployment rate of 7.4% in 2015 and 6.9% in 2016, Sweden clearly outperforms the Eurozone average (2015: 10.9%, 2016: 10.0%). Since the introduction of its strong fiscal policy and budget target framework after the recession of the mid-1990s, public debt is in decline. The last data indicate a public debt quota of 41.7% of GDP (Eurozone average: 91.7%).

The comparison between Sweden and Eurozone averages is, however, problematic because Sweden is hardly comparable to some of the Eurozone countries. Sweden is a northern, small, export-oriented, and hard currency country with above-average productivity.[7] A harder and therefore more telling test would be to compare Swedish macroeconomic performance to the respective performances of the small and export-oriented countries of Austria, Belgium, Finland and the Netherlands, all located outside crisis-ridden southern Europe. This comparison still indicates that Sweden is doing well outside the Eurozone, with better growth (the average of our four comparison countries: 1.2% in 2015, 1.7% in 2016), slightly lower unemployment (7.6% in 2015, 7.1% in 2016), and a much lower debt quota (Austria, Belgium, Finland and the Netherlands have an average debt quota of 56% of GDP).

Since 2014 when Swedish inflation had reached its low point with 0.2% only, inflation has picked up, but still remains below its 2% target.[8] Sweden runs significant trade and current account surpluses. The surpluses peaked in the years 2006/07 with more than 8% in each of the years (2007: 8.2%) and have been slightly normalizing since. With 4.7% in 2016, the current account surplus is still high, but clearly more moderate than those of Germany (8.3%), the Netherlands (9.0%) and Denmark (8.1%).[9] In line with the positive current account, the Riksbank has accumulated significant foreign currency and gold reserves (with a market value of, according to the latest data, SEK 464.8 billion, i.e. about $55.4 billion).[10]

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3 Financial Times, 21 July 2016.

4 Source: https://data.europa.eu/euodp/en/data/dataset/S2157_453_ENG.

5 Unless otherwise indicated, all data in this report are from the OECD or from AMECO, the macroeconomic database of the European Commission.

6 OECD Economic Surveys: Sweden (from February 2017), pp.6-14.

7 Measured as 2016 GDP per hour worked in $PPPs (the index is held constant for the year 2010), Sweden is wealthier than the Eurozone average ($56.4 compared to $53.1) and much wealthier than the EU average ($47.7).

8 However, the Riksbank recently reported inflation rates of 2.3% for September and 1.8% for October 2017. Source: http://www.riksbank.se/en/Monetary-policy/Inflation/Current-inflation-rate/.

9 In its latest “Review on the prevention and correction of macroeconomic imbalances”, the European Commission notes that the Swedish current account surplus is decreasing, more moderately than in the north of the Eurozone, and with limited outward spillover effects only. Source: https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-sweden-en.pdf.

10 Source: http://www.riksbank.se/en/The-Riksbank/The-Riksbanks-asset-management/Gold-and-foreign-currency-reserve/.

Major challenges for the near future are the needs to cool the housing market and to contain private household debt. Unemployment should be pushed down further. Also, inequality has increased significantly during the last years, though numbers are still better than those of most other EU or OECD countries. Notwithstanding these challenges, Sweden is obviously finding good conditions to prosper without the euro, thereby outperforming the Eurozone as a whole as well as comparable cases inside it.

4 Fixing the nominal exchange rate?

Inside the euro, Sweden would lose its capacity to de- and revalue if necessary. No country should consider ceding this if its ability to meet the ECB's inflation target was absent, because overshooting could not be corrected by exchange rate adjustments anymore. Sweden is clearly able to prevent inflation from overshooting, no matter whether we compare Swedish inflation to Eurozone averages, our four comparison cases from section 3, the ECB target, or the inflation rate of its most important trading partner Germany.[11] Sweden has nevertheless made productive use of its ability to engage in discretionary exchange rate policy in the past. During the recession years, the Riksbank allowed for a sharp depreciation of the krona against the euro, with a low point of 11.7 krona for one euro in 2009. This policy option would vanish if Sweden joined the euro. Also, as the OECD notes in its latest Economic Survey,[12] the recent upturn in Sweden's inflation rate partly reflects the previous depreciation of the krona.

An advantage of joining the euro would be that involuntary appreciations of the krona against the euro would not be possible anymore (I will come back to this in the final section). If the euro crisis returned, perhaps due to turbulences caused by southern euro exits, the Riksbank would probably have to intervene intensively in order to prevent the krona from revaluing too much. The continuing danger of a second onset of the euro crisis, however, indicates that it may be better to remain outside anyway.

5 Interest rate autonomy

As the Mundell trilemma suggests, monetary policy can – under conditions of open capital markets, which are given between Sweden and the Eurozone – never fully achieve two goals at the same time: internal macroeconomic steering and external exchange rate stabilization. Since the Riksbank does not entirely privilege external over internal stabilization (compare, by contrast, Switzerland until early 2015 and Denmark), there remains room for discretionary interest rate policy which would likewise vanish if Sweden joined the euro.

The Riksbank used this room for manoeuvre between mid-2010 and mid-2011 when it increased the repo rate from 0.25% to 2.0%, due to its concerns about rising housing prices and private household debt. It corrected this attempt soon after and even opted for a negative repo rate which persists until today (-0.5%, with a QE programme in addition), while macro-prudential measures are used to cool the housing market. This correction illustrates the conflict of aims between macroeconomic and financial stabilization. Note that this conflict of aims would not vanish if Sweden joined the euro. What would vanish is rather Sweden's capacity to choose its positioning within that conflict.

If Swedish price inflation keeps picking up over the next month,[13] the Riksbank may use its room for manoeuvre by increasing its repo rate before the ECB does so (recent signals indicate that the ECB is not willing to do so before 2019). However, note again that the room for manoeuvre of the Riksbank is larger than zero outside the euro but nevertheless limited because it simultaneously has to consider the impact of its decisions on the exchange rate. Increasing divergence between an expansionist international and a more restrictive Swedish monetary policy would also increase the likelihood of the emergence of undesired appreciation pressure.

6 Refinancing public debt

Entering the euro can, in principle, also affect the cost of refinancing public debt because the nature of risk associated with government bonds changes. The nominal devaluation risk vis-à-vis the euro area vanishes as soon as the respective country joins. This is why the risk premia of southern European government bonds converged to northern standards as soon as it became clear that they would become euro members. The vanishing of the devaluation risk, however, comes at the price

[11] However, Germany engaged in more "mercantilist" wage restraint than Sweden since the euro was introduced in 1999. Between 1999 and 2016, the economy-wide nominal unit labour cost rose by 41.5% in Sweden, compared to only 19.5% in Germany (own calculation on the basis of OECD data). If we assume nominal unit labour cost increases to be the main determinant of price inflation in the middle to long run, this should fuel Swedish inflation more than that of Germany. This is no bad news for Sweden since higher inflation is precisely what is hoped for today. But in the middle to long run, inflation divergence translates into competitiveness divergence if not corrected by exchange rate adjustments.

[12] OECD (see fn. 6), p.14.

[13] See fn. 8.

of the emergence of a bankruptcy risk. While states with sovereign currencies such as Sweden are without bankruptcy risk as long as their debt is in the currency they print, euro members become indebted in a foreign currency, the euro. This is why the spreads re-emerged once the financial and euro crisis set in.

With respect to the refinancing cost of public debt, entering the Eurozone would not make much difference for Sweden. There is no significant devaluation risk premium to remove because the interest rate on long-term government bonds (maturing in 10 years) is already very low. In the years since the introduction of the euro, the average Swedish long-term interest rate was only 0.24% higher than that of Germany.[14] Likewise, Sweden's bankruptcy risk is obviously very low, reflecting its ever declining public indebtedness. The refinancing cost of public debt would therefore, very probably, neither fall nor rise significantly if Sweden adopted the euro.

7 Entering a transfer union?

Until now, the Eurozone has not been a transfer union. The common currency has a multitude of redistributive consequences, but it lacks federation-like fiscal transfers so far. It is unclear whether this will remain so. The Eurozone is in the mid of a reform debate (see in particular the European Commission's reflection paper on the deepening of the European economic and monetary union, published in May 2017),[15] and more fiscal transfers are part of many reform concepts.

We can distinguish three possible future scenarios: first, the Eurozone may relax the existing fiscal compact and the macroeconomic surveillance procedure and establish significant transfer programmes (the dominant vision in the South, but also in parts of the political centre-left in the North). Second, the Eurozone may sharpen the existing correction procedures, adopt rules for state insolvencies, limit transnational redistribution as much as possible and, if more redistribution is unavoidable, make it as indirect and non-transparent as possible (the dominant vision in the North). Third, the Eurozone may also be stuck in an institutional immobility trap and stick to its current structure, thereby again having to act discretionarily when the next crisis sets in.

Even among the proponents of more inner-Eurozone fiscal transfers, it is often unclear what the purpose of these transfers would be. We can distinguish between at least three different possible purposes:

1. Levelling living standards: redistribution from more to less productive members.
2. Levelling refinance cost: redistribution from countries with low interest rates on government bonds to those with high rates (same effect as Eurobonds).
3. Levelling the current account by sanctioning surplus countries: redistribution from surplus to deficit countries (same effect as the so-called Clearing Union).

Note that in all three scenarios, and therefore also in a mixed scenario, Sweden would be on the side of the donor countries. Therefore, if more fiscal redistribution for whatever purpose occurred inside the Eurozone and if Sweden joined, the Swedes would have to transfer more tax money to other European states.

8 Sweden should stay out of the euro

It is fair to conclude that Sweden should not adopt the euro in the near future. The Swedish economy is in a better shape than that of the Eurozone and entering the latter would clearly have to be pushed through against the will of the majority of Swedish voters. Sweden would not profit from a decreasing risk premium on government bonds. But Sweden would lose its remaining degree of freedom in the fields of monetary and exchange rate policy. Moreover, the euro crisis is not over and the Eurozone has entered a reform process with unclear outcomes. If the Eurozone were to gain capacity for transnational redistribution, Sweden would clearly find itself in the donor camp.

The only plausible advantage of entering the Eurozone would be avoidance of unwanted appreciations of the krona. More exchange rate stability has a price due to the conflict of aims between internal and external stabilization. If the Swedes are willing to pay that price, they should, like the Danes, enter into an ERM II-like arrangement. Ironically, a formal accession to the ERM II is precisely what the Swedish government cannot do, because it would thereby fulfil all convergence criteria on its way to the euro. It could, however, enter into negotiations about a similar arrangement that is nevertheless outside the formal ERM II. Assuming that exchange rate stability on the European continent is in the interest of the Eurozone as well, it may be worth evaluating the respective preferences on all sides. Entering the Eurozone in its current state, by contrast, is not an attractive option for Sweden.

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[14] Comparison to the four country cases from section 3: the average Swedish long-term interest rate was 0.03% higher than that of Denmark, 0.04% higher than that of the Netherlands, 0.08% lower than that of Austria and 0.25% lower than that of Belgium (own calculations on the basis of OECD data).

[15] Source: https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf.