

Focus: Currency policy

SEB

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Autumn 2003 EMU referendum

Until now, our forecast of Sweden's timetable for joining EMU has been that a referendum would take place in the spring of 2003. After the prime minister's recent statements on the issue, autumn 2003 seems more likely. Sweden thus cannot join the ERM until late autumn 2003 at the earliest. The result will be a longer period of uncertainty about Sweden's EMU accession, and as a likely consequence, more prolonged weakness for the Swedish krona.

Our earlier forecast

In an interview with the Stockholm newspaper *Dagens Nyheter* last winter, Prime Minister Göran Persson stated that his goal was Swedish membership of the Economic and Monetary Union's euro currency zone by January 1, 2005. He indicated that March 2003 was a conceivable date for a referendum. Mr Persson foresaw accession to the EU's Exchange Rate Mechanism (ERM) in the winter of 2004, i.e. shortly before the the European Commission and the EU Council of Ministers begin examining Sweden's EMU membership application.

At SEB, we used these stated target dates for EMU membership and for a referendum as the basis for our own analysis, but viewed such a short ERM period as rather tight. For this reason, we forecasted that negotiations on the ERM central rate and the fluctuation band of the Swedish krona against the euro would be initiated immediately after the referendum, and that Sweden would join the ERM by the summer of 2003. We foresaw a central rate of SEK 8.60 (for a more detailed review, see "The Road to the Euro: A White Paper on the Swedish EMU Accession", SEB, February 2002).

There are major political uncertainties, and none of this has yet been decided. We are nevertheless choosing to make a politically

related postponement of our forecasted timetable. Autumn 2003 now appears to be the earliest probable date for an EMU referendum.

An autumn 2003 referendum

As soon as the prime minister mentioned March 2003 as a conceivable date for a referendum, it was obvious that the schedule was tight. Since the EMU issue will not be resolved by Sweden's September 2002 parliamentary election but instead by a separate referendum, a number of preparations for this vote must take place.

After the parliamentary election, the government will convene talks between Swedish political party leaders about the date of a coming referendum, how the question on the ballot should be formulated, the length of the campaign, the financing of campaign organisations etc. In itself, this has not changed. However, since last spring the Swedish Trade Union Confederation (LO) has clearly indicated that it does not favour an early referendum. LO wants plenty of time for discussion and information to its members, it has said. With Göran Persson staying on as prime minister – we anticipate a continued Social Democratic government – there is a strong probability that the government will go along with LO on this point.

One reason why the process will take time is that LO has demanded “buffer funds” as a condition for supporting Swedish EMU membership. Such funds would be used mainly to stabilise the labour market in the event of external disruptions which, after EMU accession, can no longer be addressed via national monetary policy.

A special government-appointed commission of inquiry has evaluated the buffer fund system in Finland and has presented recommendations on how Sweden’s stabilisation policy under EMU can be formulated. The report of the commission – a team of experts headed by a former deputy finance minister, Bengt K Å Johansson – was published last spring and was, politically speaking, an anticlimax. In a highly stringent and pedagogical way, it declared that such funds would most probably be ineffective. If fiscal policy buffers are what Sweden will need, it is better to view the central government budget in itself as a buffer and to ensure sufficient surpluses.

From the standpoint of economics, this was a highly reasonable answer. But politically speaking, it missed the point, since it did not give the government anything it could hand to LO. The buffer fund issue thus remains politically unresolved. This is a source of concern to the Social Democrats, who want LO on their side in a future “Yes on EMU” campaign.

Our conclusion is therefore that after the election, the Ministry of Finance must submit a proposal on how some kind of “buffer funds” might look. This process will take time. The public comment period for the Johansson Commission report expires on November 1. After that, a government bill must be written (perhaps preceded by a preliminary proposal, which will require an additional public comment period). Then Parliament will need time to deal with members’ bills and debate the issue before it can make a decision.

Our impression is that the **prime minister**

wants to be completely assured of a Yes vote before setting the referendum campaign in motion. This is why he is attaching great importance to bringing LO on board – which, in turn, means that he does not want to force a decision. He will let the debate and the decision on buffer funds take the time that is needed.

We do not know exactly how much of a lead in the public opinion polls the Yes side must have before the parliamentary majority dares to announce a referendum. But obviously Mr Persson wants to be completely sure of winning the referendum; under no circumstances does he want to repeat the Danish debacle. In light of this – and since the buffer fund process will take time – it is naturally tempting to hold off on a referendum until after the summer of 2003.

Another reason to postpone the referendum until after the summer – as the prime minister himself has hinted – is that one more season of European summer holiday travel will enable more Swedes to accustom themselves to euro coins and bank notes, which might make a decision to adopt the euro less dramatic.

During the current parliamentary election campaign, the opposition parties have tried to pressure the government to say when the referendum date will be announced. The non-socialists have proposed a referendum next spring. We think that the prime minister’s replies to these questions clearly indicate that at the present time, he is unwilling to announce such a vote. **The autumn of 2003 will thus be the earliest possible date for a referendum.**

However, it is far from certain that a referendum will take place even during the autumn of next year. Various pitfalls along the way may reverse public opinion. If Germany elects a conservative government that joins with its fellow ruling conservative parties in France and Italy to push EU policymaking markedly towards the right, this may adversely influence the efforts of the Swedish

Social Democrats to work more closely with the EU. Quarrels about the Stability Pact may create financial market instability surrounding the euro. Disunity on the EU budget and the terms of the enlargement process – in the worst case paired with a No vote in the Irish referendum on the Treaty of Nice later this autumn – may generate so much uncertainty about the future of the EU that it undermines public support in Sweden for EMU membership.

Conclusion: The public opinion situation will determine the timing of the referendum. But even today, the prime minister already seems to have decided that Swedish public opinion is not “ready” for a referendum before the autumn of 2003 at the earliest. However, various political controversies in and around the EU may postpone the date further.

ERM accession

If there is a referendum in the autumn of 2003 and *if* it results in a Yes vote, the government will present a bill to Parliament on Sweden’s transition to the euro. Then the government can submit an application to the EU for Swedish membership of the currency union. This procedure should take only a month, which means that the application can be submitted well before Parliament’s Christmas break.

Meanwhile, we assume that negotiations on the terms of Sweden’s ERM accession will start. They will occur in the Economic and Financial Committee, the EU agency that prepares the meetings of the finance ministers in the Council. There Sweden’s representatives (from the Riksbank and the Finance Ministry) will meet with ECB and their colleagues from the 12 EMU currency union members as well as Denmark, which belongs to the ERM. These negotiations should be possible to complete quickly; it is in everyone’s interest to avoid market uncertainty. It may open the way for the **krona to join the ERM in late autumn 2003 or by the beginning of 2004 at the latest.**

This will allow a short ERM period – only 12-14 months – before Swedish EMU membership, and only 4 months before the Council of Finance Ministers (Ecofin Council) will examine Sweden’s membership application. It is an open question whether EU leaders and finance ministers are willing to accept such a short ERM membership period. The EC Treaty stipulates two years of a stable exchange rate within the “normal fluctuation margins provided for by the exchange rate mechanism” as a condition for joining the EMU currency union. However, decisions on membership are made by the politicians in the Ecofin Council, so of course there is some flexibility concerning the required time period. Our earlier forecast assumed that it would benefit Sweden if the krona had belonged to the ERM for longer than this when the Council is going to make its decision on Swedish EMU membership.

In fact, this assessment remains valid. The EU runs a risk that granting an exception to Sweden may set a precedent when dealing with future applications by EU candidate countries to join the currency union. However, we believe that in **recent months, Sweden’s chances of passing muster even after a fairly short ERM period have improved.** The European Commission – which should be viewed in this context as the guardian of the rule system – has become weaker in relation to the Council, which is more inclined to bend the rules. This has been clearly evident in the EU’s handling of the Stability Pact; and with the present budget problems in Germany, we are bound to see more of the same.

A greater willingness to bend the rules will improve Sweden’s chances. Meanwhile, if anything Sweden’s negotiating position has become somewhat stronger, thanks to the relatively good performance of the Swedish economy. Finally, the United Kingdom’s outsider status and demands for an extremely short ERM period for the pound will probably be of some help to Sweden.

Conclusion: Our overall assessment of Sweden's chances for negotiating a short ERM period is somewhat more optimistic than before. For this reason, we believe that the EU will accept the krona as an ERM member starting in the late autumn of 2003. During the following year, the Swedish currency will thus have a fixed exchange rate against the euro. On January 1, 2005, Sweden will switch to the euro.

A weaker krona

During the past year, shifting market expectations concerning Sweden's participation in EMU have had clear effects on the exchange rate of the krona. In a situation like the one prevailing in financial markets this past year – high risk premiums, falling equity prices (especially for telecoms and information technology) – the krona tends to weaken.

Offsetting this has been the market's perception that within a few years, Sweden will be a member of the EMU currency union and that along the way, the krona must be pegged to the euro at a stronger exchange rate than today. The reasons for this expected appreciation are both the Riksbank's old calculations of the krona-euro equilibrium exchange rate (which indicated that the krona is greatly undervalued today) and expectations that the EU will demand a stronger krona in order to avoid both inflationary tendencies and special Swedish competitive advantages.

During periods when the EMU issue has been at the centre of attention – and when news reports have indicated a faster-than-expected timetable – the krona has strengthened significantly. This occurred, for example, early in 2002 after Göran Persson's interview with *Dagens Nyheter* was published. Convergence trading during the first quarter of 2002 caused the krona to appreciate from about 9.75 to about 9.05 per euro. But when the EMU issue has faded from view, stock market problems and foreign currency outflows have instead gained the upper hand and the krona has weakened again. This was the case during the late spring and summer of 2002, when the krona fell back to 9.50.

Conclusion: If ERM accession is postponed and uncertainty about the timetable for EMU membership increases – all else being equal – in the intervening period the krona may be expected to become somewhat weaker than if Sweden had joined the ERM earlier. **Convergence trading towards the expected central rate that would have preceded the referendum will be postponed.** How long this period lasts will depend entirely on the political signals about when a referendum can take place.

We will continuously update our projections of krona exchange rate developments in our regular forecast publications.

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