

Joining Europe's Monetary Club
The Challenges for Smaller Member States

Edited by

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CHAPTER NINE

Sweden and EMU

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Sweden's track record with regard to the costs and benefits of economic and monetary union (EMU), like the record of the other recent members of the European Union (EU), is rather short and uncertain. Most discussion about monetary union has been couched in more general terms concerning membership in the political union. As a result, this chapter provides somewhat of a different angle in evaluating Sweden's EMU membership. In particular, the first section offers a historical backdrop against which we can better understand Sweden's rather unique path to EMU membership. This historical section aims both to outline Sweden's previous monetary history and to describe its political path to EU membership more generally.

Each of the following sections pertains to the different types of factors that will influence Sweden's approach to EMU. The second section, on the economic criteria, addresses the potential costs and benefits according to the Maastricht convergence criteria and to more general optimal currency area criteria. This long section attempts to quantify the economic costs associated with a potential monetary union. The third section takes up the distributional and institutional issues associated with EMU. Sweden's unique institutional characteristics facilitate discussion about the distributional consequences of EMU. This section maps out the institutional and distributional fault lines. The final section, on linkage issues, describes how EMU is coupled to other issues in order to make it more politically palatable to a hesitant constituency. EMU in itself is not a main Swedish objective; it is attractive only insofar as it can be used as a scapegoat for the difficult discussions needed to rectify the current economic crisis. The chapter concludes with an evaluation of the various perspectives, speculating that Sweden

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might eventually pursue membership despite its historical record and the potential distributional costs. Whether it does rests on the ability of Sweden's political and economic elites to convince a skeptical public.

Swedish Conditions

This section introduces relevant history of Sweden in order better to understand the context in which Swedes will evaluate their potential membership in EMU. This history unfolds in two parts. The first asks: To what extent has Sweden employed active exchange rate policies in the past? An answer to this question sheds light on the degree of autonomy that Sweden will jeopardize should it join EMU. The second part of this section provides an overview of the political struggle for membership in the EU.

Exchange Rate History

Swedish monetary history can easily be read from two different perspectives. (See Moses, 1995b.) Generally, supporters of fixed exchange rates can find comfort in Sweden's long-standing commitment to such regimes. Although it joined late (1951), Sweden benefited from the relatively fixed exchange rates of the Bretton Woods system; it participated actively as a member in the Group of Ten to secure a similar environment at the Smithsonian Meetings (1971); and Sweden has been publicly committed to fixed exchange rates since the early-1980s. The Swedish krona was fixed after the "Big Bang" (16 percent) devaluation of 1982 until the 1992 crisis in the European exchange rate mechanism (ERM).

Proponents of flexible exchange rates, however, also can draw on much of Swedish history. In the theoretical realm, economists associated with the Stockholm school have long pursued an interest in real and nominal price mechanisms; the concept of purchasing power parity (PPP) in its modern variant is a legacy of this school (Jonung, 1991). In the real world as well, Swedes have used exchange rate changes effectively to defend their full employment objectives throughout most of the 1970s. Indeed, Sweden left the "snake" in 1977 to avoid what it felt was a too restrictive German monetary policy. After 1977, Sweden tried to distance itself from the price stability goal—building and actively employing a trade-weighted basket for the krona in the period from 1977 to 1991. Only in 1991 did the Swedish government decide to link the krona to an ECU basket rather than a trade-weighted one.

Throughout most of the 1980s, there was growing support for fixed exchange rates in Sweden. Before the market-forced float in the fall of 1992, there was a general consensus among the political parties—as well as among most economists—that fixed rates of exchange with the rest of

Europe were both a political and an economic necessity. But economic fads are often fickle. Fears of inflation in the wake of the substantial depreciation of November 1992 have proven unjustified. The consumer price index has remained relatively stable in recent years—2.3 percent (1992), 4.7 percent (1993), and 3.2 percent (1994)—and the competitiveness gains from the devaluation helped to spark much reinvestment in Sweden. While there is a general recognition of the enormous gains accrued by the 1992 devaluation, this has (quite peculiarly) had little impact on the nature of the debate in Sweden on EMU membership. Indeed, this mirrors the confused advice of the influential Lindbeck commission: Sweden should apply flexible exchange rates until its economic house is once again in order (Lindbeck, Molander, Persson, Petersson, Sandmo, Swedenborg, and Thygesen, 1994: 33).²

Support for Membership in the European Union

The path to membership in the EU parallels the journey just discussed above. Indeed, ECU linkage can be seen as part of a larger strategy on the part of political elites to gain Sweden back-door entry into the EU (Moses, 1997). The Swedish decision to apply for EU membership came as a shock and surprise to many; it was the result of a cataclysmic change in Swedish politics. In two years, from 1989 to 1991, most of the major political parties had completely reversed their positions on EU membership (see Sandholtz, 1995); by the 1994 referendum, all of the major political parties in Sweden came to support membership.³ The electorate followed suit on 13 November 1994, when a majority of Swedes decided to support EU membership in the national referendum. (See Moses and Jensen, 1998.) The reason for the turnaround can be explained mostly by developments on the foreign policy front. Economic arguments played a more important role only later.⁴ Sweden's European ambitions had become less problematic in that membership could be sold in terms of the country's security concerns and the solutions contained in international cooperative arrangements.

While neutrality and cooperation issues still dominated much of the debate about EU membership as Sweden approached its November referendum, skepticism had increased. One reason for this is that the Swedish economic picture had changed radically. Alongside the figures on Swedish unemployment, rank-and-file skepticism to EU membership had skyrocketed. Interest had shifted away from the positive effects of membership to its potential negative effects. Security issues were replaced by issues regarding the potential loss of sovereignty, the effect on the domestic welfare state, the threat of bureaucratic meddling from Brussels, and so forth.

An example of this anti-EU emphasis on social policy can be seen in polling figures that indicate a high degree of resistance among Swedish women to the European Union. Like their Norwegian counterparts, Swedish women are concerned that EU membership will undermine their well-developed social welfare network. In a poll taken prior to the referendum, 44 percent of Swedish women opposed, while only 33 percent supported, EU membership. (The corresponding figures for Swedish men were: 42 percent yes, 38 percent no. See *Berlingske Tidende*, 22 September 1994: 4.)

One important impetus for this change was the Danish rejection of the Maastricht agreement. In Sweden, as in the other Nordic countries, support for EU membership dropped significantly in the wake of the 1992 Danish referendum. Political and economic sovereignty issues took center stage, and public support for the EU began to fall. As Table 9.1 suggests, public opinion changed dramatically in a three-month period surrounding the Danish decision.

During the early to mid-1990s, Swedes generally were skeptical about the ability of either the EU or national politicians to deliver on issues of high political saliency. The September 1994 election can be read as a protest vote against further liberalization, but it did not provide much instruction to the newly elected (Social Democratic) minority government as to how to go about solving the most important issues. Until unemployment is again under control, larger geopolitical issues probably will remain secondary concerns, and the role of the EU will be delegated to a second-class policy issue: a hopeful means of spurring economic recovery.

In short, Sweden's historical record does not provide much ground for supporting its membership in EMU. Sweden has a long history of maintaining an

autonomous monetary policy, it has actively employed flexible exchange rates in the past to help secure its internal balance, and the 1992 devaluation was very beneficial (both politically and economically). As a result there is general support for maintaining flexible rates into the foreseeable future. In addition, support for the European Union is based less on the economic promise of an EMU and more on the potential of cooperating in international solutions. A potential monetary union was not a major selling point in the negotiations over Swedish EU membership.

Economic Criteria

This section presents the structure and makeup of Sweden's economy with an eye toward evaluating the potential economic costs and benefits of the country participating in an EMU. The first part looks at Sweden's standing with respect to Europe's so-called convergence criteria. The second looks at some particular structural elements of the Swedish economy to see the extent to which Sweden might be susceptible to asymmetric shocks given EMU.

Convergence Criteria

Sweden's record high unemployment figures are cause for the greatest concern. Unemployment continues to grow, from 5.3 percent in 1992 to around 8.0 percent for the years following. In January 1996, the figure remained at 8.1 percent.⁵ Any attempt to better Sweden's record on the formal convergence criteria is likely to influence (negatively) this politically charged variable. Thus, unemployment remains a significant background variable for evaluating Sweden's record on the convergence criteria.

If we consider only the formal convergence criteria, Sweden's budget deficits are the most worrisome element. Currently, the budget deficit is at nearly 10.4 percent of gross domestic product (GDP), leagues away from the 3 percent required by the criterion. (See Table 9.2.) Much of the deficit is set; it consists of remnants from the old Swedish model, overburdened with enormous demands by a growing army of Sweden's unemployed. So long as unemployment continues at such high levels, reducing these deficits will be difficult and costly. In addition, however, the budget deficit includes some expensive bailout programs. In particular, several Swedish banks lost money between 1990 and 1993 (to the amount of, roughly, 234 billion kronor). The state was forced to intervene and "socialize" two of the largest banks (Nordbanken and Securum), at the cost of about 36 billion kronor. These bailouts were a significant element of the deficit in the years straddling the referendum but became only marginal in the following years.

Table 9.1: Party Support for EC/EU Membership Before and After the Danish Veto (percent)

Vote	Left	Before the Danish Veto (May 1992)					New Democrat	Total
		Social Democrat	Liberal	Agricultural	Christian Democrat	Conservative		
For	8	33	63	19	37	71	42	44
Against	67	47	23	58	36	14	45	36
Other	25	21	13	23	27	15	14	19
		After the Danish Veto (June 1992)						
For	9	20	46	13	17	66	25	32
Against	88	56	32	67	58	18	57	47
Other	2	24	22	21	26	16	18	21

Source: Lindström (1992), pp. 24-5.

Sweden managed to meet just one of the convergence criteria in 1995: the inflation level criterion. However, the country's governments do not seem concerned about eventually reaching the other criteria; instead, the relevant question has been *when* Sweden can meet them. For example, a 1994 government report evaluated Sweden's position with regard to the convergence criteria and found it inconceivable that the country would manage to satisfy all of the convergence criteria before 1996 (Assarsson and Olsson, 1993). Besides fixed exchange rates (Sweden has only begun to participate in the European Monetary System), the main problem was seen to be Sweden's public finances. In 1993, the Finance Department (Finansdepartementet, 1993) figured that the government should be able to wrestle out a budget deficit in 1996 that is about 9 percent of GDP. After that period, the department expects the situation to improve radically. In its *kompletteringspropositionen* (completion proposition), the government presented a savings plan that is expected to shrink the deficit to 3.6 percent in 1998.

Annual budget deficits add up to debt. In 1993, Sweden—for the first time—exceeded the 60 percent of GDP ceiling laid out in the Maastricht criteria. How the debt situation will continue to develop, however, is uncertain. The report just mentioned did not address the debt issue according to the convergence criteria. This is interesting in that the EU apparently considers different types of public sector debt, such that parts of the debt that answer to changes in some other part of the public sector are not taken into consideration (Assarsson and Olsson, 1993:15). In the Swedish context, this means that the universal pension, or "AP" funds (that is, AP funds that are holding state obligations) are not added into the government's gross debt.⁶ Still, the European Commission's figure for the Swedish debt in 1994 was 79.9 percent of GDP.

Although the Swedish economy is suffering its worse depression since the interwar period, its government promises a stringent budgetary diet.⁷ The potential distributional costs of this fiscal fasting are discussed in the third section of the chapter. For now, it is enough to show that, in 1995, the government presented detailed plans for eliminating the deficit problem by 1998. While debt probably will remain well above the specified levels, Sweden's government hopes that the EU will forgive its debt, Irish fashion, if it sees movement in the direction of its alleviation.

In conclusion, Sweden can—and apparently intends to—effectively meet three of the four convergence criteria by 1998. The public debt problem will remain. The real question, as we shall see, is about the political sustainability of the plan. The current government, already burdened with large unemployment figures, can hardly afford to lose more jobs through fiscal consolidation in an effort to satisfy an already unpopular European objective.

General Economic Structure

This section evaluates Sweden's production and export structure with an eye toward measuring its susceptibility to asymmetric shocks. This evaluation relies on data at three different levels: export structure, general trade structure, and production composition. The underlying assumption here is that the more integrated the Swedish economy is with the other economies in the Union, the less likely that it will suffer asymmetric shocks resulting from a future EMU.⁸

Sweden's integration with the rest of Europe can be measured in several ways, the first of which is in general export terms. Fifty-three percent of Sweden's exports in 1993 went to member states of the EU; and 55 percent of its imports come from the same countries.⁹ But two of Sweden's five most important export markets, the United States (which accounts for 10 percent of Sweden's exports) and Norway (8 percent), are not EU members. Of the three main export markets that remain, Germany purchases 14 percent of Sweden's exports, while trailing after are the United Kingdom (8 percent) and Denmark (7 percent).

Of the Swedish goods being exported, road vehicles and paper products are the most important. Table 9.2 lists the five most important export items at the two-digit SITC level. As with Finland's export structure (see Chapter 4), the prominent role of Sweden's paper products' industry is troublesome from an optimal currency area perspective. Otherwise, the composition of Sweden's main exports is fairly well suited to that of the rest of the Union, if a bit concentrated. Five product groups account for 41 percent of all Swedish exports.

Another way to capture the degree of export dependence is to measure how much manufacturing production relies on foreign markets. Although suitably comparative figures are difficult to obtain, Table 9.3 attempts to gauge the share of production that is exported in some of Sweden's most significant industries.¹⁰ Like Table 9.2, Table 9.3 begins by listing the five most important export industries at the two-digit SITC level. It then lists the nearest production equivalent, in ISIC terms. In some of the most significant export sectors, over 60 percent of production is being exported: 63.1 percent of road vehicles, 71.8 percent of machinery, and 77.4 percent of Sweden's iron and steel production. In employment terms, machinery production in Sweden is very significant. At the two-digit ISIC level, 46.4 percent of industrial employment works in the manufacturing of fabricated metal products, machinery, and the like (*Yearbook of Nordic Statistics*, 1994). Thus, Sweden's production and employment base is heavily reliant on export markets.

Previous authors have tried to capture Sweden's degree of economic integration by measuring its reliance on intraindustrial trade (that is, the degree

Table 9.2: Five Most Important Swedish Export Items, 1993

SITC Product Group	Description	Export Share (percent)
78	Road Vehicles	12
64	Paper and paper products	10
74	General industrial machinery	7
76	Telecommunications equipment	6
67	Iron and steel	6
Total export share of all five products		41

Source: Yearbook of Nordic Statistics (1995).

Table 9.3: Top Five Export Industries and Export Composition of Manufacturing, 1992

SITC Code	Export Industry Description	Share in Total Exports (percent)	Nearest Product Equivalent	
			ISIC Code	Description
78	Road vehicles	13.1	384	Transport manufacturing
64	Paper, paper products	11.0	34	Paper, paper products
74	General machinery	7.3		
72	Specialized machinery	5.1	382	Machinery
67	Iron and steel	5.7	371	Iron-steel, basic industry

Source: Yearbook of Nordic Statistics (1994, 1995).

to which a country imports and exports goods that are identical or nearly identical). In particular, Assarsson and Olsson (1993: 49) have employed a Grubel-Lloyds (GL) index for measuring Sweden's reliance on intranational trade.¹¹ This index represents the share of intranational to total trade worldwide (Greenaway and Milner, 1986: 59-70). Assarsson and Olsson found the Swedish export economy to rely fairly heavily on intranational trade, compared to other EU-economies (with Britain scoring highest, and Greece the lowest). At the interindustrial level, Sweden's record is equally middle of the road. This interindustrial figure reflects both a country's openness and its reliance on intranational trade. (See Assarsson and Olsson, 1993.) The larger the figure, the more exposed an economy is to price

changes in the world market. In other words, Sweden's average performance suggests that it is not particularly susceptible to price shocks, compared to other EU member states.

The final step is to quantify the susceptibility of Sweden's economy to stochastic shocks. Previous studies have employed vector-auto-regression models that try to quantify the risks of a country's participation in a monetary union, measured in terms of correlation between shocks (both type and size) in various countries. (See, for example, Bayoumi and Eichengreen, 1992a and 1992b.) A country is assumed to benefit from joining a monetary union if its shocks are strongly and positively correlated with shocks in the other countries. Assarsson and Olson (1993) have applied such an analysis to Sweden and found that shocks to the Swedish economy are correlated only very weakly with corresponding shocks in other EU countries. Indeed, which other countries were considered made little difference to their results. But they also found that domestic shocks were not dominant in the Swedish economy; this was especially true for domestic supply shocks (the effects of which were found to be relatively small in comparison with the effects that arose from either demand shocks and/or foreign supply shocks). Thus Assarsson and Olsson (1993) conclude that the risks of Swedish membership in EMU, in terms of the costs of asymmetric shocks, should be limited.

The most significant difference between Sweden and the EU, in terms of production structure and vulnerability to shocks, is that Sweden is a net exporter of forest industry products (which totaled 3.6 percent of GDP in 1991). All of the EU countries, except Finland and Portugal, are net importers of forest products. Swedish exports of some types of workshop industries are also significantly larger than the Union's net exports, while its net imports of textile goods are large compared to those of the EU. It is in these sectors that there is the greatest likelihood for asymmetric shocks.

In general, then, the Swedish economy—when compared to the other EU economies—does not seem particularly ill-suited to participating in EMU. Sweden can, with some strain, meet most of the convergence criteria and might even be forgiven its debts. In terms of its production and export structure, the picture is not particularly convincing one way or the other. Sweden is, like many other member states, fairly well integrated with the other member state markets. Its production structure is not particularly vulnerable to stochastic shocks, with the possible exception of the timber and some workshop industries. The relevant question, as it is with so many other member states, depends on the government's willingness to swallow the bitter pill: Will it accept higher unemployment figures in exchange for being a member of the inner circle? It is to this question that the next section turns.

Institutional Cleavages and Distributional Consequences

This section combines two distinctive categories, distributional and institutional consequences, into one section, as they overlap so frequently on many issues. Institutions in the Swedish context largely reflect distributional interests. Institutional cleavages arise primarily along three frontiers: labor market, party political, and bureaucratic. On the other hand, the distributional consequences reflect class, sectoral, and regional interests. We turn first to the institutional cleavages.

Institutional Cleavages

One of the most relevant institutional features of the Swedish economy is the highly organized nature of its industrial relations. In terms of both bargaining coverage (83 percent) and union density (83 percent) rates, Sweden scores among the world's highest (Traxler, 1994: 173). Whereas other countries may have higher bargaining coverage rates (for example, Austria and Finland), Swedish union density levels are the highest in the world. Sweden is also one of the few countries in the world in which union density rates continue to increase over recent decades. While there is great controversy as to whether or not centralized labor unions and bargaining arrangements contribute to greater nominal wage increases (see Calmfors and Driffill, 1988; and Holmlund, 1993), Lindbeck et al. (1994: 36) argue that multi-level negotiations contribute to total larger wage increases than do single-level negotiations. In this respect, Sweden is less concentrated than other nations.¹² Indeed, Traxler (1994: 175) characterizes Sweden's capacity for economy-wide coordination as "limited."

What are the consequences of this institutional structure for facilitating (or exacerbating) the effects of shocks? Of primary importance is the degree to which unions can contain wage demands in the aftermath of devaluation or adjust wages efficiently in the event of an asymmetric shock in the context of a currency union. As Froats (1995) has argued, the structure of industrial relations has much to say about the effectiveness of potential currency unions.

Swedish industrial relations are currently in a state of flux. As a result, it is difficult to say much about the effects of these institutions in an EMU context. In the past, the highly centralized nature of industrial organization has facilitated the use of devaluations—as wage guarantees could be secured in private before devaluation. (See, for example, Bergström, 1987: 198.) Such coordination could be equally useful in a currency union. Whether these guarantees and coordination can continue in today's more fragmented context, however, remains to be seen.

Coordination is difficult, as much of the collective bargaining framework has broken down. Traditionally, labor markets in Sweden have been understood in terms of an institutional arrangement characterized by cooperation between two centralized peak bargaining organizations representing capital (the Swedish employers' federation, SAF) and labor (the trade union confederation, LO). In practice, several smaller bargaining organizations were also represented. Until recently, private sector negotiations were regularly conducted between the SAF, the LO and the "white collar" workers federation (PTK) at the national level. In the public sector, negotiations are between the government's own bargaining representatives (SAV), the public sector "white collar" union (TCO) and the other principal public sector union (SACCO). As the LO covers about 90 percent of all blue-collar workers in Sweden, and the TCO covers about 70 percent of all white collar workers, collective agreements between the government, the SAF, and the two main labor organizations were able to guarantee a fairly stable investment environment, thereby ensuring even growth.¹³ In 1983, however, exposed sector unions and employers broke out of the collective bargaining arrangement. Since then, there have been several, largely unsuccessful, attempts to return to the security of the previous collaborative negotiations structure. The result has been a move toward a more fragmented bargaining process, at the expense of the general price trend and structure as well as the investment environment.

Although there may be ideological reasons for blaming labor market institutions for the current sluggish economy, the data do not support the position wholeheartedly. Price rigidities and wage inflation do not appear to be the cause of the current problems. In Sweden, product real wage growth was significantly larger than productivity growth rates in the years from 1973 to 1977. Since 1978, however, Swedish product real wages grew at considerably restrained rates and fell below productivity growth rates. Although these figures are somewhat outdated, one can assume that the institutional features in Sweden has relaxed only in the period since 1987 and that wage rigidities cannot be held responsible for the current unemployment levels. The *Nordic Economic Outlook* (14 November 1994) reports that Swedish wage increases between 1993 and 1995 (predicted) underscored productivity increases: the reason was that wage demands were very modest and that there were cuts in social payroll charges of about 3 percent. Thus Swedish industrial organization does not appear to hinder the possibilities for the efficient wage adjustment necessary in a single-currency context.

Sweden's institutional setting offers another unique aspect to the EMU debate: as a result of these institutions, the debate about EMU membership in Sweden is probably the most developed in the Nordic region. The main reason for this is the relative autonomy of the LO's economic policy unit.

Whereas the Social Democratic Party has strongly (if sometimes quietly) supported Swedish membership in EMU, the labor unions in general have been skeptical about the costs to labor of prioritizing price stability at the (possible) expense of full employment.

Whereas the peak labor organizations in both Norway and Finland have more or less towed the Labor (Social Democratic) line, the LO in Sweden has aggressively attacked the Social Democratic line on monetary policy priorities in the editorial pages of Sweden's largest newspaper: *Dagens Nyheter*. On 24 June 1990, the chief economist of the LO, P.-O. Edlin, and Dan Andersson (another leading LO economist), criticized Allan Larsson (then finance minister) and the rest of the Social Democratic economic group for sacrificing the full employment objective on the altar of price stability. Allan Larsson returned the joust with an editorial two days later entitled "LO Economists Capitulate."¹⁴ Although one might expect sectoral divisions within each group that would oppose either position, the LO's position represents a general concern that the government's EU ambitions were placed ahead of all other policy options, including full employment.

The peak bargaining organization for capital interests (SAF), on the other hand, has voiced no such hesitancy in its support of EMU membership for Sweden. Despite sectoral (and size) divisions within the membership, the SAF is a strong (and wealthy) ally of the pro-EU movement (including EMU membership). Though economists at the SAF realize that the decision to support EMU membership for Sweden may provoke some sectoral strains within the organization, they argue that the economic benefits (not only in terms of reduced transaction costs, but also in terms of investment dynamics) make the position attractive to the SAF.

The second potential institutional divide is among Sweden's political parties. One might expect that some social groups prefer inflation (or monetary policy autonomy) more than others—and would influence party positions accordingly. Yet—like Finland, and as was discussed in the historical section—all of Sweden's major parties support membership in the European Union; and they have not exerted great effort to clarify their position with regard to future EMU. Instead, the parties all seem to agree about the basic type of economic measures that are required, but they are afraid to be caught taking the costly measures. For example, Carl Bildt's Moderate (read: Conservative) government prescribed neoclassical medicine for Sweden's economic woes. His government introduced a series of measures, including limits on interest-rate deductions, new pension-saving measures, less regulation of stockholders, and weaker social-insurance measures. But eventually this government was removed from office in large part because of its ambitious restructuring and deficit-cutting goals. Fiscal conservatism is not seen

as necessary on its own (in political terms); but the size of the deficit clearly makes it necessary in economic terms.

To the extent that parties reflect different sectoral interests, they might be expected to have different positions with respect to Sweden's participation in EMU. The agricultural (center) parties in the rest of the Nordic region are examples of such differentiation. But farmers (and foresters) are less politically influential in Sweden than in Norway or Finland. As much of the farming lobby is dominated by larger, export-oriented concerns in the south of Sweden, the Center Party and the farmer's lobby have been less adamant (than their counterparts in, say, Norway) about keeping Sweden out of the European Union and EMU. Thus, party cleavages do not appear along a number of anticipated (sectoral) fault lines.

One final institutional divide is between the government and the central bank, Sveriges Riksbank. This is not an uncommon cleavage, but it has been exacerbated of late by increased calls for greater central bank autonomy in Sweden (as elsewhere). Actually, Sweden is the first of the Nordic countries to come out with a formal parliamentary report on the status of the Riksbank with respect to the proposed changes in EMU's third stage of transition, and to provide for some appraisal of the consequences for Sweden (Statens Offentliga Utredningar, 1993: 20). Although politically contentious, the report made several recommendations about the primary objectives of central bank policy including a series of institutional changes to ensure greater autonomy for the central bank and a firm institutional and legal commitment to price stability as the primary objective of the Riksbank.

This independence has shown itself most recently in a fairly open split between the government and the Riksbank over the degree of enthusiasm shown for the third stage of monetary union. In mid-June 1995, for the first time, the Riksbank announced that Sweden should join EMU, saying that it offered "overriding advantages" for the economy (Carnegy, 1995a). This strong and open support for membership is quite at odds with the government's restrained position. Although the then government, in particular Ingvar Carlsson (the prime minister) and Göran Persson (the finance minister), indicated support for Sweden joining the final stage of EMU, it was very careful to stress that the decision will ultimately be taken by parliament—where there is certain to be much opposition. This careful strategy on the part of the government probably will continue as long as opinion in Sweden is skeptical of membership.

Distributional Consequences

From these institutional cleavages we can expect several potential distributional consequences. The most important distributional divide has to do

with the employment costs associated with meeting the initial criteria for joining a monetary union, and the possibilities of painful asymmetric shocks once Sweden is in such EMU. These divisions might be expected along class, sectoral, and regional lines.

In 1994, Sweden's unemployment rate soared to 14 percent (including those on training schemes) from below 5 percent just three years earlier. The unemployment problem is worse in the mid-1990s than it has been in the past 60 years. As the convergence criteria section documented, this has led to enormous budget problems.

Estimating the potential costs of meeting the convergence criteria is no easy matter and there can be much disagreement over the particulars of each study. On average, however, the government predictions, unsurprisingly, are much lower than outside estimates. Three external studies, however, are not very encouraging. First, *Veckans Affärer*, a business paper, estimated that tying the krona to an ECU basket cost Sweden a decline in productive potential valued at between 120 and 150 billion kronor, which corresponds to about 5 percent additional unemployment. Later another business paper, *Månadens Affärer*, estimated that the employment costs of meeting the Maastricht criteria (according to the government's current strategy) ranges between 300,000 and 400,000 jobs.⁵ Finally, in a study carried out by the National Institute for Economic and Social Research (London) for the European Parliament, it has been estimated that the Swedish economy will sacrifice 250,000 jobs in its fiscal entrenchment (Bartell, Morgan, and Pain, 1995).

Generally, we can expect two types of distributional consequences to result from both the convergence stage and the currency union phase of EMU. Meeting the convergence criteria will have distributional consequences on two constituencies: public policy patrons and public sector employees. Balancing the budget and paying off the debt burden will have significant distributional and employment consequences (Moses, 1995a). Not only will social spending need to be pruned radically, but the economy itself will experience disinflationary pressures. These consequences are only exacerbated by the fact that the reforms are being forced under the EMU's time constraint. Resistance can be expected from all who benefit from social spending as well as from the growing number of unemployed.

Providing more specific predictions about the distributional fallout of these policies, especially in the private sector, is more difficult. After EMU is established, however, two major divisions affecting employment may emerge. First, the tradable and nontradable sectors may divide over the distribution of adjustment costs (Frieden, 1991). Regions that are heavily dependent on sheltered industry incomes might be expected to lose relative to other regions, because of the loss of an autonomous monetary policy. Alter-

natively, those regions that rely heavily on forest industry products may be less able to cope with a monetary policy aimed at different (that is, pan-European) business cycles from those that influence the forest industry.

Measuring the regional effects of these changes is not easy. Swedish fiscal policy is not designed along regional terms, as it is in some of the larger countries. There are few regional aid packages, and they are not listed as such in the government's budget. Instead, regional business cycles are handled within the general, national framework of a large network of job-matching facilities and resources. Thus regional transfers are not a significant, detailed budget item. Instead, the costs of regional economic downturns (either structural or cyclical) are listed (fiscally) under the larger social welfare and labor rubrics of the budget.

Nevertheless, it is possible to examine the regional contributions to the gross domestic product and provide some rough estimate of which regions will be hardest hit in all three of the above scenarios. Tables 9.4 and 9.5 can help us in this endeavor. Table 9.4 reveals that the costs of cutting public sector employment will be spread fairly evenly across all of Sweden, with Stockholm and the smaller regions being hurt the least, in part because they rely less on public sector contributions. Public concerns represent over 20 percent of the regional product in most of the remaining regions provided for in the Finance Department's reports (Finansdepartementet, 1994). The employment effects can be expected to be (roughly) the same.

In evaluating the potential costs that might result from asymmetric shocks to different regions after the establishment of EMU, the northern and most sparsely populated regions are likely to be hurt the most because they are more heavily reliant on forest industry production. In addition, however, Table 9.5 suggests that the "regional centers" and Stockholm will be hit hard by their proportionally heavier reliance on sheltered industry incomes.

Whereas the economic costs are difficult to quantify, the political costs might be more clear-cut. After the 1994 referendum, the EU became very unpopular in Sweden. On 15 June 1995, Sweden's Central Statistics Bureau published a poll of 74,000 voters (an unusually large sample) in which 61.9 percent of them said that they would reject joining the EU if a new referendum were held. Only 28.6 percent voiced support (Carney, 1995a). If government officials are not able to convince their voting publics that Sweden's current economic hardships are not the result of an attempt at EMU, or if the public begins to see the convergence criteria (and not full employment) as the government's primary economic objective, the government's popularity will go the way of the European Union's.

To sum up, Sweden's institutional framework is currently in flux, so it is difficult to predict how useful this framework will prove in the context of

Table 9.4. Sectoral Contributions to Regional Production in Sweden, 1991

Region	Regional Product	Sectoral Subdivisions					Aggregates	
		Agriculture	Industry	Services	State	Local	Private	Public
Stockholm	353,000	0.7	19.1	60.7	5.4	12.5	80.4	18.0
Göteborg	137,300	0.8	24.1	54.6	3.7	15.8	79.5	19.5
Malmö	94,300	2.3	25.7	49.5	4.6	16.9	77.5	21.5
Large Southern Centers	229,600	3.0	31.1	42.3	4.8	17.8	76.4	22.6
Regional Centers	338,400	3.8	29.8	41.8	5.1	18.3	75.4	23.5
Local Centers	205,900	3.7	40.3	35.2	2.8	17.1	79.2	19.9
Smaller Regions	52,400	8.6	35.5	33.2	3.3	18.5	77.3	21.8
Small Regions	36,400	5.4	43.3	33.5	2.3	14.4	82.2	16.7
National	1,447,000	2.7	28.6	46.7	4.5	16.2	78.1	20.7

Note: For more detailed descriptions of the 8 regions, see Finansdepartementet (1994: 20). The determining factor is the number of inhabitants in a commune. The cut-off numbers for each of the 8 regions are as follows: > 1,000,000; > 750,000; > 500,000; > 150,000; > 75,000; > 25,000; > 12,500; < 12,500.
Source: Finansdepartementet (1994), p. 32.

a future EMU. In the past, centralized bargaining structures have enabled the Swedish economy to adjust efficiently to large asymmetric shocks. Distributional fallout can be expected to result from the fiscal constraints imposed on potential EMU members as well as the possible asymmetric effects arising from Sweden's relative dependence on forest industry exports. Employees in the public sector, current beneficiaries of public policy, and the timber industry generally can be expected to be affected negatively and disproportionately.

Linkages

EMU membership often is linked to other issues. Meeting the convergence criteria is bitter medicine, but it is medicine that the finance minister would prescribe, regardless of the ailment. In other words, the convergence criteria have become the scapegoats for difficult decisions. In particular, two types of linkages reflect these largely negative concerns: fear of capital flight and the need for fiscal rectitude. Obviously, the two issues themselves are linked.

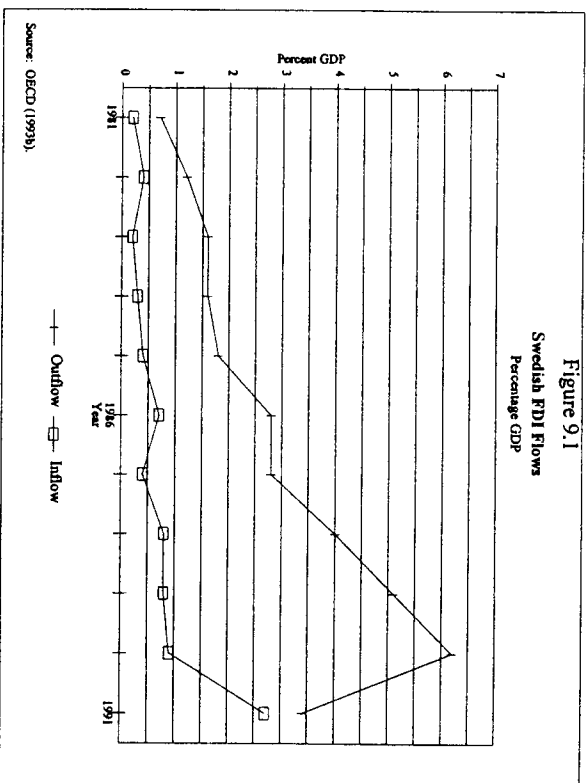
Table 9.5. Regional Industrial Production Shares by Sector (average percent 1990 and 1991)

Region	Regional Product	Industry				Industry intensive in:			
		Manu- facturing	Sheltered	Labor	Capital	Knowledge	R&D		
Stockholm	24.4	15.4	20.6	4.7	6.3	10.0	44.0		
Göteborg	9.5	9.0	7.5	6.3	13.3	12.5	2.5		
Malmö	6.5	5.9	8.3	7.6	3.3	5.4	4.7		
Large Southern Centers	15.9	17.8	18.6	18.5	12.1	18.4	23.7		
Regional Centers	23.4	25.0	21.1	28.4	31.0	26.4	14.7		
Local Centers	14.2	20.0	17.7	24.0	25.5	20.7	8.8		
Smaller Regions	3.6	4.1	4.3	5.6	5.0	4.3	0.3		
Small Regions	2.5	2.8	2.0	4.9	3.5	2.4	1.2		
National	100	100	100	100	100	100	100		

Note: For more detailed descriptions of the 8 regions, see Finansdepartementet (1994: 20). The determining factor is the number of inhabitants in a commune. The cut-off numbers for each of the 8 regions are as follows: > 1,000,000; > 750,000; > 500,000; > 150,000; > 75,000; > 25,000; > 12,500; < 12,500.
Source: Finansdepartementet (1994), p. 48.

Of all the Nordic countries, Sweden's economy is the most industrialized and the most susceptible to the threat of outward flows of investment capital. Swedish industry and investment traditionally has been linked to a handful of large concerns, whose interests in Europe have played an enormous role in the debate about European membership and Sweden's interest in an eventual monetary union. An example of this influence can be seen in the run-up to the 1994 parliamentary elections. The chiefs of Sweden's four top exporting companies threatened to withdraw their domestic investments (totaling about 50 billion kronor per year) in Sweden if income tax levels in the country were changed after the election.¹⁶ This was little more than an open threat to the Social Democrats that, in the wake of their almost certain electoral victory, they must continue to pursue the economic policies established under Moderate Party rule. Although the executives' concern was aimed mostly at proposed changes in Swedish tax levels, similar pressure can be seen on the monetary/exchange-rate front.

Figure 9.1
Swedish FDI Flows
Percentage GDP



Source: OECD (1993b).

With the lifting of foreign exchange controls, Swedish capital is no longer constrained to the collective bargaining table and has fled to Europe in search of higher yields. This flight had an enormously stifling effect on domestic investment in Sweden until the 1992 devaluation. Over the past four years, industrial investments have declined rapidly and the capital stock in industries actually has been declining. The volume index (1985=100) for gross fixed capital formation in Sweden dropped off dramatically from 1990 to 1993: 129.8, 118.9, 106, and 87.3, respectively (*Yearbook of Nordic Statistics*, 1995: 288). Since the devaluation, some Swedish capital has returned, and the domestic investment outlook seems hopeful. Nevertheless, a cloud still hovers over the Swedish investment environment. As capital's fear of devaluation, inflation, and transaction costs are lessened by movement in the direction of EMU, government officials can explain the potential benefits of EMU in terms of satisfying capital's demands.

The second linkage issue is the one associated with fiscal rectitude. Several officials in the central bank and in government have alluded to the fact that the convergence criteria are difficult but necessary in order to help put Sweden's economic house back in order. For example, the Riksbank, in its first formal announcement of support for Sweden's joining EMU, explained its decision in the following terms: "The economic policy which enables Sweden to participate in EMU is essentially the same as the policy that is

needed for a lasting recovery in the Swedish economy after the decline in recent years" (Carnegy, 1995a: 3). In short, balanced public finances, controlled public debt, lower inflation, lower interest rates, and currency stability are the instruments chosen by the government and bank to try to rebuild the Swedish economy—regardless of EMU membership. This was, for example, the advice of the Lindbeck report (Lindbeck et al., 1994).

These two linkage issues suggest that EMU-participation in its own right is not desirable. That is, I believe, true. Sweden recognizes the need to participate for fear of potential investment flight; it also understands the need to get its fiscal house in order. But Sweden does not argue for EMU in its own right—EMU has become a means to other ends. In this respect, the discussion about EMU parallels those outlined in the historical section: Support for the EU is made on much broader grounds than its potential economic effects. But public support for EMU, and the EU in general, remains weak.

Swedish discussions on peace, defense, and social policy often are framed in pan-European terms. Sweden desires to participate in a cooperative European venture to secure objectives that are no longer (if ever) obtainable at the national level. This concern for Europe, however, does not carry over to discussions about monetary policy. The discussion about joining EMU (or not) is not framed in terms of the potential or economic benefit to Europe as a whole.

Conclusion

This chapter has attempted to gauge the support (and its price) of Swedish membership in EMU. To do so, it has considered a variety of historical, economic, and political vantage points. Unfortunately, these manifold perspectives do not provide a common or focused vision of Sweden's potential for membership. Still, in summary, we might offer a cautious conclusion.

The historical perspective is critical of Sweden's ability to participate in EMU. In the past, Sweden has relied on exchange rate flexibility and has been most willing to prioritize full employment over price stability. To the extent that these historical norms are embedded in current Swedish preferences, support for Swedish membership in EMU should be small. But there is pressure to change this historical consensus.

Sweden's standing with respect to the economic criteria offers more ambiguous lessons. The government and the central bank intend to meet the Maastricht criteria, and likely will do so (with the exception of the debt criterion). Should Sweden enter the final stage of EMU, its economic structure is probably broad enough to sustain the assaults of asymmetric blows. The Swedish economy is integrated as much as those of the other core member

states. Its economy (unlike that of Finland, Greece, and Portugal for example) does not distinguish itself remarkably in its makeup and/or size. In other words, the costs of Swedish participation in EMU will be similar to those for countries on the continent.

The strongest support for Sweden's membership in EMU comes from the more political perspective. Fear of capital flight, a newfound enthusiasm for fiscal conservatism, and the potential benefits of full membership in the other realms of the EU argue strongly for meeting the Maastricht criteria. In contrast to Sweden's historical preferences for monetary policy autonomy, and despite the potential costs of losing that autonomy, Sweden's elites strongly support membership in EMU. But public support for EU membership, including participation in EMU, is weak. As a result, Sweden's political elites are unwilling to commit themselves to EMU. In the end, Swedish membership in EMU will depend more on the ability of elites to convince a skeptical public than on any of the sundry economic costs and criteria involved.

Notes

1. I would like to thank Jeffrey Frieden and Erik Jones, along with all of the other members of the EPG, for their comments and suggestions over the many drafts of this chapter. Of course, I alone remain responsible.
2. The Lindbeck commission's advice was confused in the sense that it held, on the one hand, that Sweden maintain a floating exchange rate for quite some time; on the other hand, the commission offered support for EMU membership in principle, "at least from a narrow monetary perspective" (Lindbeck et al., 1994: 42).
3. The Liberal Party, since 1989, has been at the forefront of the Swedish EU movement. It is strongly assisted in this measure by the New Democracy Party. These two parties are the strongest and oldest supporters of EU membership. In addition, a sizable wing of the Moderate Party has long advocated Swedish EC membership. Its party chairman (later prime minister), Carl Bildt, was enthusiastic about the European Economic Area (EEA), but worried that Swedish membership in the EU might delegate it to a "peripheral state" in Europe. By June of 1990, however, Bildt—and the reluctant wing of the Moderate Party—became confirmed as new believers to the European project. The Christian Democrats have been more cautious supporters. The Social Democratic leadership has long supported EC membership, but the party did not officially support the project until the fall of 1990. The Center Party traditionally has been skeptical of the membership movement and often was grouped together with the Greens and the Left Party as active opponents to EC membership. Their position over time, however, has weakened somewhat. Both the Green and Left parties have been, and remain, vehement opponents to Swedish EU membership.
4. One reason for this apparent lacuna was the (contemporary) Swedish decision to agree to participate in the European Economic Area (EEA). Throughout the latter part of the 1980s, Sweden had joined the other EFTA countries in bargaining for increased access to the European market. A large majority in the Swedish Riksdag had supported the EEA agreement, which came into place on 1 January 1994.
5. If those workers on government training schemes are also included in the figures, then the unemployment levels are 5.7 percent (1992), 8.9 percent (1993), and 14 percent (1994).
6. AP funds are a huge public pension fund system established in the 1960s. At their peak, in the early 1970s, these funds accounted for 35 percent of the total supply of Swedish credit (Pontusson, 1992: 12).
7. In June 1995, the government came out with an updated report on the costs associated with meeting the criteria. To accomplish this, the government proposed large cuts in the budget, totaling 18 billion kronor in both 1998 and 1999. These cuts, in addition to increased tax incomes, were designed to better the budget by 117 billion kronor. In addition, the government proposed to sell off about 70 billion kronor worth of assets (publicly owned facilities and firms). This, combined with hopes of a 3 percent growth rate over 1996–97, was intended to eliminate the budget deficit by 1998.
8. I assume that the reader is generally familiar with the optimal currency area (OCA) literature. If not, I recommend the introductions provided by De Grauwe (1994), De Grauwe and Vanhaverbeke (1991), Ishiyama (1975), and Masson and Taylor (1992).
9. All of the figures in this paragraph come from the *Yearbook of Nordic Statistics* (1995).
10. The most recent year for which we could obtain comparative statistics was 1992. In that year, Sweden's export structure was different from that in 1993: Specialized machinery was replaced by telecommunications equipment in the ranking. Contrast Table 9.3 with Table 9.2.
11. While these figures rely on two-digit SITC data, Hansson (1989) has shown the difference in Sweden at other digit levels (up to six) to be negligible.
12. For a comparative description of different bargaining levels and co-ordination, see Golden and Wallerstein (1995) and Table 5.1 in Traxler (1994: 175).
13. For reference, it may be useful to note that the community, social and personal service industries (SITC 9) represent 40 percent of Swedish employment. This is followed by manufacturing (18 percent) and wholesale and retail trade (14 percent). See *Yearbook of Nordic Statistics* (1995). Thus, the non-LO peak organizations that represent white-collar service sector workers control a significant share of Swedish employees.
14. This debate eventually found its way to an LO-Social Democratic Party (peace-offering) seminar, the contents of which (and the original *Dagens Nyheter* editorials) have been printed as Carlsson (1991).

15. This would be the equivalent of doubling the number of registered unemployed. In 1994, there were 340,000 registered unemployed in Sweden.
16. The four were Sören Gyll, chief executive of Volvo; Lars Ramqvist, chief executive of Ericsson; Bert-Olof Svanholm, chief executive of Swedish ABB; and Bo Berggren, chairman of Stora. Their threat came by way of an open editorial in the *Dagens Nyheter* (12 September 1994).

CONCLUSION

The Political Economy of EMU: A Small Country Perspective

Erik Jones, Jeffrey Frieden,
and Francisco Torres

For the smaller countries studied in this volume, context is what matters in debates about economic and monetary union (EMU): How does monetary integration fit into their larger political and economic objectives? What are the keys to preparation for EMU, and what are the pitfalls? Finally, does economic and monetary union hold implications beyond what is expected or even desired?

The answers to such questions tell a lot about the political economy of EMU, even if they do not reflect the structural position of smaller countries. What is at issue is “best practice” and not strictly costs and benefits—although doing what is best is sure to influence the net result of integration. Therefore, this chapter draws together what we believe to be the lessons from the small-country perspective.

The chapter has five sections. The first examines the link between EMU and broader economic strategies, such as liberalization, modernization, and diversification. Building on that analysis, the second section asks whether credibility is more important than real convergence—whether EMU truly can serve a broader economic strategy, or if the broad strategy must be completed before monetary integration can be attempted. The third section examines how different political and economic arrangements can facilitate or hinder the process of adjustment to monetary union, and the fourth suggests that there may be disadvantages to placing monetary questions outside the realm of political accountability or as the focal point for domestic debate. The fifth section forms a conclusion.