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Bernhard Duijm and Bettina Nürk*

Scandinavia's Monetary Convergence with the European Community

In the twelve months preceding the conclusion by the EFTA countries and the EC of the agreement on the establishment of a common European Economic Area in October 1991, the three Scandinavian EFTA members – Norway, Finland and Sweden – decided to tie their currencies to the ECU. What objectives do these countries hope to achieve by this move? What effects is it likely to have?

The process of integration in the European Community moved into a higher gear when the Single European Act was signed in February 1986, and the publication of the Delors Report in April 1989 gave added weight to the striving for monetary integration. Ever more countries are showing a growing interest in participating in the convergence of the EC countries in the economic and monetary spheres. Austria, Sweden, Turkey, Cyprus and Malta have already applied for membership of the Community or intend to do so in the near future. Eastern European countries such as Poland and Czechoslovakia regard the association agreement they are seeking with the Community as a transitional phase on the path to full EC membership. The countries of the European Free Trade Association (EFTA) concluded an agreement with the Community on the common European Economic Area in October 1991. Some of them want to go beyond this mainly functional merger and have already taken steps to align their economic and monetary policies with those of the Community. On 22nd October 1990 Norway announced its decision to tie the Norwegian krone to the ECU at a rate of Nkr. 7.9940. Some months later – in May and June 1991 – Sweden and Finland followed suit, fixing exchange rates of SKr. 7.40054 and FMk. 4.87580 to the ECU.

What political and economic objectives do these three countries hope to achieve by tying their currencies to the ECU, and what effects is this likely to have? The answers to these questions depend not least on whether the exchange rate policies they pursued previously were compatible with these objectives. We shall therefore examine this aspect before considering the question of the

link with the ECU and its political and economic connotations. In assessing their decision, it is also necessary to consider whether a different exchange rate policy might not have served their objectives better.

Exchange Rate Policy Hitherto

After the demise of the Bretton Woods system of fixed exchange rates in 1973, the Northern European countries considered that the conditions for allowing their currencies to float independently were not met. They therefore tried to stabilise their exchange rates as far as possible by a variety of means:

- Norway and Sweden joined the European exchange rate "snake", which had been established in April 1972 and whose member countries agreed fixed but adjustable exchange rates between their currencies. The weighted exchange rates of the Norwegian and Swedish currencies nevertheless fluctuated fairly widely in the next few years, owing mainly to the fact that they continued to float against important currencies such as the US dollar, the yen and sterling. The sometimes very pronounced movements affected the price competitiveness of domestic suppliers in both countries, and hence domestic production as well.
- Finland, by contrast, decided as early as 1973 to link the Finnish markka to a basket of currencies. The aim of such a link is to hold the external value of the currency stable against an average of other currencies in order to limit the effect of exchange rate fluctuations on the domestic economy. Any appreciation or depreciation against one or several currencies in the basket must be offset by opposite and equal exchange rate adjustments against other currencies. If this is not achieved by market forces, it must be brought about by official exchange market intervention. Hence, whereas the bilateral exchange rates of the markka

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against national currencies in the basket were flexible, its average exchange rate remained constant.

Sweden and Norway left the snake in 1977 and 1978 respectively and decided that they too would peg to a currency basket of their choice. Despite the fact that the exchange arrangements of all the Northern European countries now took the form of a basket linkage, the national arrangements differed and were modified on several occasions. Immediately before the switch to the ECU link, the following arrangements applied:

□ Finland's currency basket consisted of fourteen currencies – twelve European currencies plus the US dollar and the yen. Individual currency weights were determined by each country's share of Finnish merchandise exports and imports. A currency was included in the basket only if the share averaged at least 1% during the previous two years. Fluctuations of 3% on either side of the central rate were permitted.

□ Sweden's basket of currencies contained fifteen currencies. As in Finland, weights were based essentially on each country's share of Sweden's foreign trade, although the reference period was considerably longer, five years. Shares in the basket did not wholly correspond to trade shares, however, as the weight of the US dollar was doubled in view of the international importance of the currency as an invoicing and payment medium, and the weights of the other currencies were adjusted accordingly.

Here too, the basket consisted only of the currencies of countries whose trade accounted for at least 1% of the total. The margins within which the exchange rate was permitted to fluctuate were only half as wide as those set in Finland, namely $\pm 1.5\%$.

□ Norway's currency basket was made up of the fourteen currencies of greatest importance for the country's foreign trade and payments. Weighting was based on countries' shares in Norway's exports of finished goods, allowance being made for competition with these countries in third markets. In this way not only the direct effects of changes in the exchange rate of the foreign currency on bilateral trade and payments could be taken into account, but also the indirect effects via third markets. Fluctuations of 2.25% on either side of the central rate were permitted.

The weights of each of the Scandinavian currencies in the currency baskets of the other two countries clearly demonstrate the degree of interdependence in foreign trade (Table 1).

It is clear that the composition of all three currency baskets was such that fluctuations in the exchange rates of important currencies had the least possible effect on the domestic economy and especially on the competitiveness of export industries. The Norwegian basket was better able to achieve this objective than the other two, as competition in third markets also influenced the weighting.¹

Unlike Norway and Sweden, Finland pursued an exchange rate policy that was more akin to managed floating rather than a consistent policy of exchange rate linkage. Whereas in Sweden the weights of individual currencies were adjusted once a year for changes in shares of foreign trade and in Norway actually remained unchanged from August 1985 onwards, Finland revised its weightings every three months. In this way, the Finnish currency could be devalued without this having to be expressed in a change in official central rates. The wider 6% fluctuation band and the frequent realignments (which also occurred in Sweden and Norway, in fact) enabled the Finnish authorities to pursue a relatively independent economic and monetary policy.

The statement by the Bank of Sweden that tying the krona to a basket of currencies was a good means of achieving the objective of stabilising trade and the balance of payments² can certainly also be applied to Norway and

Table 1

Exchange Rate Interdependence between the Nordic Currencies in 1987

	Percentage weight in the currency basket of:		
	Norway	Sweden	Finland
Norwegian krone	–	9.4	5.6
Swedish krona	15	–	20
Finnish markka	3	7.2	–

Source: Own compilation based on H. Edison and E. Vardal: Optimal currency basket in a World of Generalized Floating. An Application to the Nordic Countries, in: International Journal of Forecasting, Vol. 3 (1987), pp. 81-96.

Table 2

Trade with the EC as a Percentage of the Three Northern European Countries' Total Trade in 1988

	Sweden	Norway	Finland
Imports from the EC	55.9	46.4	43.2
Exports to the EC	52.1	65.1	43.1

Source: United Nations: Handbook of International Trade and Development Statistics 1989, New York 1990, pp. 113-132.

¹ Cf. Dick Kling: Effect of Foreign Exchange Policy on the Swedish Economy, in: Wirtschaftspolitische Blätter, Vol. 35 (1988), pp. 143-149, here p. 148.

² See "The Swedish ECU-Peg: Motivation and Technical Solutions", Press Notice of the Sveriges Riksbank, in: Deutsche Bundesbank: Auszüge aus Presseartikeln, No. 38, 24th May 1991, p. 13.

Finland. But why have these three countries now switched to tying their currencies to the ECU? Or does this exchange rate move merely represent "a change in the content of the baskets already being used"?³

Objectives of the Northern European Countries

The three Northern European countries hope that linkage to the ECU will bring both economic and political advantages.

Stabilisation of Trade Relations. For years, the exchange rate policy of the three Scandinavian countries has been aimed at shielding their foreign trade as far as possible from the effects of exchange rate fluctuations. The EC countries are by far the most important trading partners for all three (Table 2).

The importance of the EC for the foreign trade of the three countries can be expected to increase further in a common European Economic Area. The Scandinavian countries hope their new exchange rate system will reduce the exchange risk for a large proportion of their foreign trade and payments, since linking their currencies to the ECU is synonymous with linking them to practically all the EC currencies.

Stabilisation of Economic Policy. Bringing long-term stability and discipline to economic policy is one of the most important reasons for the decision by the three Scandinavian countries. Whereas Norway's inflation rate of 4.1%⁴ in 1990 was only slightly higher than the average of just under 3.9%⁵ for the 12 EC countries, Sweden especially must bring down its high inflation rate, which was 10.2% in 1990. In Finland too consumer prices increased considerably faster than in the Community, rising by 6.2%⁶. By pegging their currencies to the ECU, the Northern European countries therefore aim to subject

their economic policies to stronger automatic stabilisation pressure than in the past. They even hope to see some stabilisation effect in the short term via a curbing of inflation expectations,⁷ as in recent years price rises in the European Community were less than the average for the countries in their previous currency baskets.⁸

Preparation for Eventual EC Membership. For Sweden in particular, the reasons for linking the currency to the ECU were not only economic but also political. Sweden is the only one of the three countries so far to express its intention of achieving full membership of the European Community within the next few years. Linkage to the ECU is seen as a symbolic act and the first step in a three-stage strategy. The change in the orientation of exchange rate policy is to be followed by participation in the exchange rate mechanism of the EMS.

The ambitions of Norway and Finland do not extend quite so far. Norway is thinking of at least an association with the EMS – indeed, many observers see ECU linkage as the first step towards eventual EC membership, as in the case of Sweden – but the official line in Finland is that the

³ Robert Taylor: Linkage to Ecu signals Nordic area's intentions, in: Financial Times, London and Frankfurt, 7th June 1991.

⁴ The figures that follow are based on OECD data; see Ifo-Institut für Wirtschaftsforschung: European Economies in Graphs and Figures 1970-1992, Munich 1991.

⁵ National inflation rates have been weighted with the current share of each EC currency in the ECU. The calculations are based on OECD data; see Ifo-Institut für Wirtschaftsforschung, op. cit.

⁶ From 1987 to 1989 the Scandinavian countries recorded the following inflation rates: Norway: 8.0%, 6.3%, 4.4%; Sweden: 5.3%, 6.4%, 6.5%; Finland: 3.7%, 4.6%, 4.8%. According to our own calculations, the EC average weighted with the current ECU shares was 2.7%, 2.9% and 4.3% in the same years; see Ifo-Institut für Wirtschaftsforschung, op. cit.

⁷ Cf. "The Swedish ECU-Peg", op. cit., p. 14.

⁸ Cf. "Finnmark ab Freitag an ECU gekoppelt", in: Frankfurter Allgemeine Zeitung, 5th June 1991, and OECD Economic Surveys 1990/1991: Norway.

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**INSTITUTIONAL ASPECTS OF ECONOMIC
INTEGRATION OF TURKEY
INTO THE EUROPEAN COMMUNITY**

VERLAG WELTARCHIV GMBH – HAMBURG

country does not yet want to draw any closer to the Community or its monetary system.

Here too, political considerations may be paramount. Finland remains very concerned to preserve its neutrality. In the light of the political and economic upheavals in Eastern Europe, this appears to be more easily reconcilable with EC membership than a few years ago. On the other side of the balance, however, are the endeavours of the EC member countries to establish a Political Union, which would include a common foreign and security policy.

Stabilisation of Trade Relations within Scandinavia. The Finnish Government did not even let a month pass before following Sweden's decision; on 7th June 1991 it announced that it too was linking its currency to the ECU. The Swedish decision, in turn, had been expected since October 1990, when Norway had taken the same step. Incidentally, Norway had announced this move only two weeks after the United Kingdom joined the exchange rate mechanism of the EMS on 8th October 1990.

For Finland, the decision to peg the markka to the ECU may perhaps have been spurred less by fear of exclusion from the process of European integration than by the fact that such a move was considered unavoidable in view of the change in the exchange rate stance of Norway and Sweden. All three countries have very strong trade ties with one another. In 1988 as much as 14% of Finland's exports went to Sweden and around 13% of its imports came from that country.⁹ Similarities in the composition of their output also lead to keen competition in third markets, especially in the paper and wood industries. If Finland were to use different reference currencies than Norway and Sweden, exchange rate fluctuations between the currencies of the three countries and their implications for trade among themselves and with third countries would have been unavoidable.

Table 3

The Present Composition of the ECU

Currencies	Percentage shares
Deutsche mark	30.1
French franc	19.0
Pound sterling	13.0
Italian lira	10.15
Dutch guilder	9.4
Belgian franc	7.6
Spanish peseta	5.3
Danish krone	2.45
Irish punt	1.1
Greek drachma	0.8
Portuguese escudo	0.8
Luxembourg franc	0.3

Source: Institut der deutschen Wirtschaft (ed.): *Wirtschaft und Unterricht*, Vol. 17 (1991), No. 6 (Supplement to Informationsdienst des Instituts der deutschen Wirtschaft, Vol. 17 (1991), No. 30).

Let us now examine and assess the probable effects of linkage to the ECU in the light of the objectives described above.

Consequences of Linkage to the ECU

Stabilisation of Trade Relations. By pegging their currencies to the ECU, the Northern European countries will undoubtedly create a better basis for stabilising their trade relations with the countries of the European Community. Ten of the EC currencies are linked together by fixed but adjustable exchange rates via their respective ECU central rates. Portugal and Greece do not officially belong to the ERM. Whereas Portugal has successfully taken unilateral and voluntary action to stabilise the escudo against the other European currencies since the beginning of 1990,¹⁰ Greece's rather half-hearted attempts at stabilisation have not managed to establish a relatively stable exchange rate between the drachma and the other EC currencies. However, the weight of the drachma in the ECU is very small, as is that of the escudo (Table 3).

Leaving aside the Greek drachma and possibly the Portuguese escudo, pegging a currency to the ECU leads to a reduction in the fluctuations in its bilateral exchange rates against national EC currencies. The currency's fluctuation band for each currency from then onwards is determined by the permitted margins for the two currencies either side of their ECU central rates. The considerable lessening in exchange risk will tend to lead to closer trade links between Northern Europe and the EC.

With the previous individual currency baskets, by contrast, wide fluctuations in bilateral exchange rates were possible, although the basket arrangement did mean that the trade weighted external value of the Nordic currencies remained relatively constant, so that external exchange rate fluctuations had very little effect on the level of the trade balance or on the balance-of-payments position. With the ECU link, however, changes in the value of the dollar and yen, in particular, will affect the trade weighted exchange rate and hence the trade account and the balance of payments of the three countries, since the ECU contains only European currencies. Greater exchange rate stability vis-à-vis the EC will therefore be

⁹ For the absolute figures, see OECD Economic Surveys 1988/1989: Finland, p. 132.

¹⁰ Cf. "Zusammenwachsen des europäischen Währungsblocks", in: *Neue Zürcher Zeitung*, Fernausgabe No. 125, 4th June 1991.

¹¹ The composition of the ECU is not optimal even in the light of other stabilisation objectives usually pursued by means of linkage to a currency basket; see Maku Kotilainen and Tapio Peura: Finland's Exchange Rate System and European Integration, in: *Kansallisen Economic Review*, 1/1989, pp. 36-44.

achieved at the cost of increased vulnerability to disturbances originating in the yen and dollar areas. Tables 4 and 5 show how important the USA, Canada and Japan are for the Scandinavian countries' external trade.

Although the composition of the ECU is not optimal as far as stabilising the trade and balance-of-payments position is concerned,¹¹ it has to be considered whether the ECU's function as an international payments instrument might not contribute to an intensification of trade between Northern Europe and the EC. Whereas the currency baskets used previously simply represented indices, the ECU is a standard basket,¹² so that it can perform monetary functions and hence simplify calculations for Scandinavian exporters and importers. If they use the ECU as a currency of invoice and means of payment, the basis on which they calculate the invoice amount in domestic currency will be more reliable, which will have an overall stabilising effect on the Scandinavian countries' trade with the EC. Similarly, the Northern European central banks will no longer have to make valuation adjustments in their balance sheets for exchange reserves in ECUs. Of course, both advantages only apply as long as the parity against the ECU is kept constant.

Even if the ECU meets the technical requirements to perform various monetary functions, this does not necessarily mean it will actually be used in international transactions.¹³ It is now being used by some central banks as an intervention currency and as a reserve currency – in Norway, for example.¹⁴ The ECU now occupies a prominent position as the currency of denomination for loans on the Euro-capital market, especially for issuers from the Nordic countries. On the other hand, it plays a very minor role as a currency of invoice in merchandise trade and is little used as a payment instrument, although the ECU money market is growing steadily.

In overall quantitative terms, the ECU still performs only very modest monetary functions by comparison with many national currencies. For the very reason that it is not yet used as an invoicing and payment medium in private

transactions, Scandinavia cannot expect to derive much trade advantage from the ECU as a monetary instrument.

Stabilisation of Economic Policy. Linkage to the ECU could make a positive contribution to currency stabilisation, as it can be expected that for political reasons the three Nordic countries will avoid central rate adjustments if at all possible. In the past they repeatedly devalued against the central rates of their currency baskets. Desisting from exchange rate adjustments is not only necessary if their inflation rates are to converge with the EC average, but essential if the markets are to give credence to their avowal of a stability policy. In the case of Sweden, the aim of joining the EC within the next few years is a further incentive. In any case, they will no longer be able to make "covert" central rate adjustments by modifying the currency weightings in order to evade the automatic discipline and necessity to adjust that can derive from linkage to a currency basket.

As the average inflation rate in the EC countries in recent years has been lower than those in the former basket currency countries, linkage to the ECU can be seen as a sign that the Northern European countries are increasingly giving higher priority to fighting inflation than to maintaining full employment.¹⁵ A serious disadvantage, however, is that in future their inflation rates will be determined by the weighted average of the inflation rates in EC countries and by the weighted deviation of the exchange rates of all the EC currencies from their purchasing power parities.¹⁶ Hence, assuming their ECU

Table 4
Trade with the USA and Canada as a Percentage of the Foreign Trade of the Northern European Countries in 1988

	Sweden	Norway	Finland
Imports from North America	8.3	8.4	7.1
Exports to North America	11.6	7.3	6.9

Source: United Nations: Handbook of International Trade and Development Statistics 1989, New York 1990.

Table 5
Trade with Japan as a Percentage of the Foreign Trade of the Northern European Countries in 1988

	Sweden	Norway	Finland
Imports from Japan	6.4	4.7	7.4
Exports to Japan	1.8	1.9	1.8

Source: See Table 4.

¹² A currency basket is described as a standard basket if it is composed of fixed currency amounts. Besides the ECU, the Special Drawing Right of the International Monetary Fund is also a standard basket.

¹³ With regard to the following remarks, see Kommission der Europäischen Gemeinschaften (ed.): Der ECU, in: Europäische Dokumentation 5/87, Luxembourg 1987, pp. 30 ff.

¹⁴ Cf. Norges Bank: Annual Report 1989, Oslo 1990; according to this source, more than 10% of Norway's foreign exchange reserves consist of ECUs.

¹⁵ Cf. Robert Taylor, op. cit., p. 13.

¹⁶ Cf. Michael Connolly: Optimum Currency Peg for Latin America, in: Journal of Money, Credit and Banking, Vol. 15 (1983), pp. 56-72, here p. 63.

central rates remain constant, Norway, Sweden and Finland cannot reduce inflation below the level approximately corresponding to the average of the inflation rates in the EC countries. Had they tied their currencies to a single currency of above-average stability, the disciplining effect on economic policy would have been greater.

The Northern European countries, and Sweden and Finland in particular, may have decided against a single-currency peg because they feared that the internal stabilisation this would have required could not be achieved in the short term. The result would have been relatively frequent central rate adjustments, thus failing to meet the objective of exchange rate stabilisation and possibly further undermining the confidence of the markets in the economic policy being pursued by Government and central bank.

The credit lines that the Scandinavian central banks have been granted by their counterparts in the EC to enable them to maintain their ECU central rates undoubtedly provided a further reason for choosing the ECU as the unit of reference. For example, Norway has received credit assurances of ECU 2 billion from EC central banks.¹⁷ This amount would undoubtedly not have been provided by a single central bank if the krone had been pegged to a single currency.

Preparation for EC Membership. Linkage to the ECU or to a stable EC currency is a necessary step if a country aspires to membership of the Community. Tying its currency to the ECU has given Sweden an opportunity to prove that it can bring inflation down at least to the EC average and to keep it there.¹⁸ In view of the efforts to establish the monetary union, a country's chances of being admitted to the Community will be greater the more its economic policy and performance accord with the Community's striving for convergence.¹⁹

Intensive negotiations are in progress on the economic policy and performance criteria for future members of a European Monetary Union. These would apply to existing EC countries as much as to new entrants. Countries such as Greece, which have proved unable or unwilling so far to accept and submit to the Community's standards of stability, would probably be denied admission.

Stabilisation of Trade Relations within Scandinavia. The Nordic currencies are no longer present in each other's currency baskets. They will be tied together via their ECU central rates, so that their exchange rates can be expected to continue to move broadly in parallel. However, this will be true only if the three countries do abstain from making autonomous devaluations or revaluations against

the ECU. Parity adjustments would have to be co-ordinated as far as possible, for the devaluation or revaluation of one of the three would no longer automatically trigger compensating exchange rate adjustments in the neighbouring countries, as with the individual currency baskets.

Need for an Appropriate Economic Policy

The change in exchange rate arrangements in Northern Europe will also have consequences for the Community in the fields of foreign trade and monetary policy. Linkage to the ECU reduces the exchange risk not only for Scandinavian exporters and importers trading with EC countries, but also for firms in Community countries doing business in Norway, Sweden and Finland. Moreover, since the Nordic states' decision increases the number of countries pursuing a more or less parallel exchange rate policy vis-à-vis third currencies, primarily the US dollar,²⁰ the potential impact of concerted exchange market intervention by EC central banks is further enhanced. The European Community will therefore develop into an ever more important and powerful bloc on the international monetary scene.

Whether the Northern European countries can really achieve greater exchange rate and price stability by linking their currencies to the ECU depends essentially on developments within the EMS. Inflation is currently accelerating in EMS countries, even in Germany, the anchor of the system. On the other hand, low inflation in the EMS countries does not guarantee price stability in Scandinavia; to achieve this requires an economic policy consistent with linkage with the ECU.²¹ The dismantling of foreign exchange restrictions and the absence of devaluations during the changeover to the ECU link demonstrate that the Northern European countries are willing to adopt such a policy. Scandinavia has therefore fulfilled important preconditions for widening the area of internal and external monetary stability that the EMS aims to embody.

¹⁷ Cf. Deutsche Bundesbank: Geschäftsbericht für das Jahr 1990, Frankfurt 1991, p. 66.

¹⁸ With margins of 1.5% on either side of the ECU central rate, giving a total band width of only 3%, Sweden has also chosen the narrowest limits within which the exchange rate will be permitted to fluctuate. Norway's band amounts to 4.5% and Finland's to 6%.

¹⁹ According to Haberler, Tower and Willett, a similarity of views on the desired economic policy is among the preconditions for an optimum currency area; see, for example, Gottfried Haberler: The International Monetary System: Some Recent Developments and Discussions, in George N. Halm (ed.): Approaches to Greater Flexibility of Exchange Rates, Princeton 1970, pp. 115-123.

²⁰ Yugoslavia's decision in the summer of 1990 to tie the dinar to the Deutsche mark may be recalled in this connection.

²¹ See Bernhard Duijm: Wechselkurspolitik für Entwicklungsländer, Munich 1990, pp. 151 ff.

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