Svein Gjedrem: Price stability is not self-generating

Opening address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference on historical monetary statistics hosted by Norges Bank, Bogstad gård, Oslo, June 2005.

The Charts in pdf-format *can be found on the Norges Bank's website.*

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Introduction

We can learn from the past, so that we are better equipped to make the right choices in the future.

This is the second conference on historical monetary statistics hosted by Norges Bank. The conference was arranged for the first time last year, when we presented a book on historical monetary statistics. The Bank's objective has been to obtain data that can be used in research in two of the Bank's core areas, monetary policy and financial stability. Our statistics are compiled in close cooperation with academic institutions, primarily the Norwegian School of Economics and Business Administration. Later today, Professor Ola. H. Grytten will be presenting historical wage statistics from 1730 up to 2004.

Historical research can be used to shed light on economic relationships and perhaps reveal patterns. The next reasonable step would seem to be to search for the answer to the question "what is the norm?"

What is the norm?

An examination of 500 years of price history in Norway is of particular interest to monetary policy. History shows that price stability is the norm, and that high inflation is a phenomenon associated with war, times of famine and the 1970s and 1980s. Executive Director Jan F. Qvigstad will give a more detailed presentation of the characteristic features of periods in price history that do not follow the norm – periods of high inflation and strong deflation.

Once a norm has been established, the next question might be: What would the future look like if we make projections on the basis of what we know from history? Two variables of special interest for economists are GDP and consumer prices. One way to make a projection is to extend trends in historical developments. If economists in 1905 had had access to today's statistical concepts and techniques, they might also have performed exercises such as this. Let us imagine that they did just that, and that they wanted the answer to the following question: What will be the level of prices and real income in Norway when the country's citizens commemorate the dissolution of the union with Sweden in 2005?

From our position in the present, we can say with some certainty that they would have been considerably off the mark. Looking back, it is also easy to understand why.

In 1905, prices had remained approximately unchanged for several decades. The krone's precursor, the speciedaler, and then the krone itself had been pegged to silver and gold standards since 1842. These systems provided a fixed nominal anchor for the economy and for prices. This was also the case for several of our trading partners. From 1875, Norway was also a member of the Scandinavian currency union. A more detailed description will be provided by Professor Lars Jonung.

Economists of the time could not, based on historical evidence, predict that national and international monetary systems would be facing substantial disturbances that would push up the price level considerably and lead to extensive instability. With the First World War, the gold standard was suspended and the money supply and price level rose sharply. The deflationary policy of the 1920s brought the price level down, but probably also contributed to instability. The price level rose again during the Second World War, when the occupying powers used the printing press to finance a substantial portion of their expenditure. The economic policy of the 1970s and 1980s contributed to high inflation.

So, how well would economists in 1905 have predicted the Norwegian level of real income in 2005?

They would have been off the mark here too. They were not in a position to predict that the growth rate in the Norwegian and global economies would rise as a result of considerable technological progress, restructuring and higher productivity.

On the other hand, they could to some extent have predicted our current industry structure based on their economic history. From 1865 to 1900, primary industries' share of total GDP fell from about 34 per cent to 22 per cent. In the same period, manufacturing, other goods production and service industries accounted for an increasing share of total GDP. In 1900, about 24 per cent of GDP was generated by manufacturing and other goods production.

If the economists of the time had projected developments in these three industries, they would have estimated that primary industries' share of total GDP would fall to below 5 per cent. Manufacturing and other goods production would increase its share to 30 per cent and service industries to 66 per cent.

Value-added in primary industries fell somewhat more than economists in 1905 would have projected and service industries increased somewhat less. They would have been less accurate in their projections for developments in manufacturing. Although manufacturing's share of total GDP increased up to the beginning of the 1950s, growth in private and public services gradually bypassed manufacturing, and the petroleum sector held an increasingly important position from the 1970s. The expansion of the petroleum sector and the use of petroleum revenues contributed to maintaining high growth in Norway, while other countries experienced a slowdown.

Are there lessons to be learned from the pitfalls of projecting or trend-extending economic variables?

Lessons to learn

First, one lesson to learn is that it very difficult to predict developments in the real economy. If we were to extend the historical growth trend today to predict the future level of income, we would probably also be considerably wide of the mark. Today, we know nothing about the technological innovations that might appear in the future. But we do know that there will be new processes and products and that the industry structure will change in directions that cannot be foreseen now. Nor can we exclude the possibility that Norway may enter a lengthy period of stagnation, for example when the petroleum sector is scaled back.

Another lesson is that price stability is not self-generating. In the event of substantial disturbances and an unsuccessful economic policy, the economy may lose its nominal anchor. As a result, inflation may accelerate or be too low or negative, and production may become very unstable.

As the country's central bank, we take our work to safeguard price stability very seriously and we will continue to work towards this end. We set the key rate from month to month while keeping in mind the three-year horizon, but the objective is to generate confidence in stability in the value of the krone in the long term. Those of us who are still alive at the turn of the next century, will see if we achieved this objective.