Svein Gjedrem: Dialogue with boundaries

Introduction by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference “Dialogue without boundaries”, Karlstad, Sweden, 9 March 2005.

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

Please note that the text below may differ slightly from the actual presentation. The speech does not contain new assessments of the economic situation or of current interest rate setting.

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Introduction

This year, Norway is commemorating the centenary of the disolution of the union with Sweden. In retrospect, the dissolution was a painless process. Norway’s internal affairs were not affected by the union with Sweden. Historically, a national monetary system and central bank have been an important part of nation-building. The Norwegian Constitution of 17 May 1814 did not provide for a national monetary system. This was first included in the Constitution in November 1814 because of fears that the union with Sweden would bring the work on a national monetary system to a halt[1]. In 1875, the Storting decided to join the currency union that Denmark and Sweden had established two years earlier. Danish, Swedish and Norwegian notes and coins circulated and were used as legal tender in all three countries.

Open financial markets, close trade ties and a common labour market provided then as now opportunities for high economic growth and prosperity. An example is the Norwegian company Norsk Hydro, which was established the same year as the dissolution of the union. Substantial investments were required and foreign capital was crucial to the company’s establishment. Moreover, it may be worth noting that the kinship between Norway and Sweden was important in this context. Kristian Birkeland and Sam Eyde, together with the Swede Marcus Wallenberg, are considered as the founders of Hydro.

Trade between Norway and Sweden was considerable, with a fairly high degree of labour flows between the two. In the 1800s, a law was enacted providing for a common market for trade in goods, but in 1888 Sweden adopted a more protectionist stance. In 1897, Sweden rescined this law, which led to a severe setback for Norwegian exports.

Close ties between Norway and Sweden have thus been important. They also favour regional development, particularly for regions far from national centres but closer to the economic hub in the neighbouring country. Monetary policy does not give any particular weight to regional considerations. But a monetary policy that safeguards monetary values in the long term and seeks to stabilise economic developments in the short and medium term will also contribute to promoting regional development.

Long-term economic developments

Consumer prices and economic growth in Norway and Sweden moved on a fairly similar path during the years around the dissolution of the union and up to the beginning of the 1970s.

There are several reasons for this. First, we have been part of and been influenced by the same international business cycles. Second, we have close trade relations, even if there were setbacks during the interwar period and the two World Wars. Third, both countries participated in various fixed exchange rate systems for long periods. After World War II, we adhered to the international fixed exchange rate system Bretton Woods.

During the period 1900 to 1970, the Norwegian and Swedish economy grew at an average annual rate of 3.2 and 3.3 per cent respectively.

With Norway’s emergence as an oil nation, a change occurred. The Norwegian economy continued to grow at about the same pace. From 1970 to date, the Norwegian economy has expanded by an

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1 Report no. 39 (1983): Act on Norges Bank and the Monetary System

annual average of 3.4 per cent. The development of the petroleum sector and the use of petroleum revenues contributed to relatively high growth also in the mainland economy. In Sweden, however, growth fell to an annual average of 2 per cent.

Business sector competitiveness in Norway

After Norway became an oil nation, competitiveness in the business sector in Norway deteriorated in relation to Sweden. First, wage growth in Norway has been somewhat higher than in Sweden. Second, the value of the Norwegian krone against the Swedish krona has appreciated sharply.

The rise in labour costs in local and common currency was particularly high in the mid-1980s and after 1997. Hourly labour costs for a Swedish manufacturing worker were on average 8 per cent higher than for a Norwegian manufacturing worker in 1980 measured in common currency. In 2004, however, hourly labour costs for a Swedish manufacturing worker was almost 20 per cent lower[2]. Competitiveness in Norway's manufacturing industry is now close to 20 per cent weaker than the average for the past 30 years.

Norwegians had to pay close to 138 Norwegian kroner for 100 Swedish kronar in 1970. Today, we only have to pay a little more than 90 Norwegian kroner. The appreciation of the Norwegian krone has made it less expensive to buy goods and services in Sweden.

During longer periods, the exchange rate seems to have been influenced by changes in prices for export goods and import goods in the two countries. In the 10 years to 1983, the Norwegian krone showed a particularly strong appreciation against the Swedish krona. This occurred at the same time as Norway experienced far more favourable developments in prices for its export goods relative to import goods than was the case for Sweden. Norway's terms of trade improved. In the 1970s, the sharp rise in oil prices contributed to this.

In practice, the appreciation of the Norwegian krone against the Swedish krona occurred when the Swedish authorities devalued their currency more than the Norwegian authorities. The authorities devalued against a basket of currencies. In Sweden, the Palme government's devaluation of 16 per cent in October 1982 was particularly strong. Finland responded by devaluing its currency by 6 per cent. In Norway, industrial leaders and industry organisations also pressed in favour of a devaluation of the Norwegian krone. Norway's finance minister Rolf Presthus characterised the Swedish decision as a serious setback for Nordic cooperation[3], and chose not to change the value of the Norwegian krone.

In much of the 1970s and 1980s, economic policy in Norway and Sweden lacked a long-term approach and credibility. This contributed to wide swings in production and employment. With a policy of low interest rates and devaluation, inflation became entrenched at a high level. Frequent devaluations in the period following 1976 could not prevent a weakening of the manufacturing sector in the long run. On the contrary, they proved to be self-reinforcing. The wide fluctuations culminated in a borrowing spree that started in the mid-1980s, first in Norway and then in Sweden. The borrowing spree was succeeded by deep economic crises.

Both Norway and Sweden had to abandon their fixed exchange rate policy in 1992. Important reasons were freer capital flows, deeper financial markets and hence a surge in cross-border capital movements.

Sweden switched to inflation targeting in 1993 and was among the first countries to introduce a system that would later become the norm for small and medium-sized economies. The Riksbank succeeded fairly quickly in anchoring inflation expectations and keeping inflation low and stable in Sweden. Norway followed suit in March 2001.

With floating exchange rates, the exchange rate may adapt to changes in growth prospects and changes in the terms of trade. Since the end of the 1990s the Swedish krona has depreciated against the Norwegian krone. During this period, Norway has experienced a considerable rise in prices for

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2 Source: The Technical Reporting Committee on Income Settlements, Report no. 1, 2005, preliminary version. The estimates take account of both actual hourly wages and indirect costs.

3 Aftenposten, October 1982

export products such as oil and aluminium, partly owing to high demand in China. Sweden, on the other hand, has been influenced by a slower rise in prices for goods such as ICT products.

The close trade relations between Norway and Sweden are of benefit to both countries. Even if petroleum exports to Sweden rose sharply in the 1970s, Norway still ran a trade deficit with Sweden.

We have needed goods from Sweden to build up our petroleum sector, and increased wealth has enabled us to increase goods imports from Sweden. Norway has thus maintained its import share of traditional goods from Sweden while our export share to Sweden has declined. Weaker business sector competitiveness in Norway in relation to that of Sweden is probably one important factor.

Looking ahead, some of the features we have observed over the past 30 years may change. There is an imbalance between the cost level in Norway and in Sweden. The cost differential cannot be sustained in the longer term. The high cost level in the Norwegian business sector is adapted to a situation where we are developing the petroleum sector and phasing in the use of petroleum revenues into the mainland economy. After a period, we will be able to cover a smaller share of our imports using current petroleum revenues and by drawing on capital in the Petroleum Fund. The Norwegian cost level will then have to be dampened, also compared with that of Sweden. Competitiveness may in the longer run be brought back to the level prevailing at the end of the 1960s before Norway became an oil nation. During such a period of adaptation, which may start in 5 or 10 or 15 years, a flexible exchange rate, with a fall in the Norwegian krone against the Swedish krona, will have to play an important role.

Where do we stand today?

Tariff barriers for trade in goods are low. The EU/EEA agreement also provides for increased trade in services. During the 1990s, capital mobility has increased to a level that is higher than 100 year ago. Free capital flows and free trade pave the way for high economic growth and prosperity, but also entail challenges.

Competition has increased in many industries. Labour-intensive processes are being transferred to new EU member states such as the Baltic countries. Some multinational companies have streamlined various production processes and distribution and centralised them in the same location. Saab has been acquired by General Motors and Volvo by Ford. In periods, this has given rise to unrest among local authorities and employees, for example in the traditional manufacturing city of Trollhättan. In Norway, many large multinational companies have closed down operations at home and established their main offices and warehouses in the Stockholm or Malmö/Copenhagen area. Both the Norwegian costs level and population density have been of disadvantage to use with regard to these structural developments.

Sweden has partly responded to strong international competition by continuing to develop new and improving existing products and processes. The country has also become a Nordic financial centre by being the home country to four large financial conglomerates. As mentioned the Norwegian economy has benefited from good prices for our export products and proximity to petroleum activities provide Norwegian manufacturing with advantages. However, our oil dependence and a lack of diversification in our industry structure are a source of concern as regard long-term developments

Conclusion

Monetary policy’s most important contribution is to provide the economy with a nominal anchor. Today, inflation targeting is the norm for small and medium-sized economies. Exchange rates fluctuate, but there are several ways of hedging against fluctuations. After Sweden switched to inflation targeting, the country has experienced solid output growth and low and stable inflation compared with the previous decades.

Since 2002, inflation has fallen sharply both in Norway and Sweden. Between December 2002 and March 2004, the key rate was reduced by a total of 5.25 percentage points in Norway. During the same period, the key rate in Sweden was lowered by 2.25 percentage points, but from a lower level.

Two years after we started lowering interest rates in Norway, there are signs that inflation is moving up, albeit slowly. The interest rate cuts have had a pronounced impact on demand, output and employment.

We cannot expect the interest rate to have the same impact from one period to the next. The economy is also exposed to unexpected disturbances. As a result, we cannot fine-tune economic developments using the interest rate, but avoid the largest effects when the economy is exposed to disturbances. The experience of Norway and Sweden may indicate that inflation expectations remain stable even if inflation varies somewhat, as long as the interest rate is used actively to moderate the effects. With our highly open economies, we may have to accept somewhat wider swings than some countries.