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Norway and the Euro

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The Issue

The topic - Norway and the Euro - can be approached from two different angles. The first would be: The euro is here. How do we conduct monetary policy in light of this fact? The alternative is: We have a monetary policy. What is the impact on this policy of the merger of 10 foreign currencies into one, with four more as candidates within the EU´s present membership?

Most analysts have taken the first approach. That is by itself a good reason for taking the second. In addition, I generally think it is better to discuss policy by taking its purpose as a starting point rather than starting with the environment in which policy will be conducted.

But let us first consider a few facts concerning the euro´s position in our external relations. The attached table (page 10) presents the relative importance of foreign currencies measured first by weight of the respective countries as competitors, both on export markets and on our domestic market, and then by the countries` weights in our imports and Mainland Norway´s exports. Measured either way, the euro will be the single most important currency in our external relations, and its importance will be almost doubled with the inclusion of the currencies of our closest neighbours east, west and south. From this simple fact one may be tempted to conclude that Norway will be best served with a currency which is more or less a copy of the euro. That might have been so if a currency were only a means of settling trading accounts. But it also enters into financial transactions over time. This time perspective is the subject matter of monetary policy.

Then let us return to our main theme and ask: What is our present monetary policy? There could be two answers to this. One would be as it follows from the regulation on exchange rate policy which was issued in 1994 the way this was understood and practiced in the ensuing years through 1998. This regulation still stands. The other is the policy that follows from the way the regulation has been interpreted by the new governor, Mr. Svein Gjedrem, who took office on January 1, 1999 and which has been elaborated in the Board´s submission to the Ministry of Finance of October 21, 1999.

[1] I am grateful to my colleague Arne Jon Isachsen for many helpful comments to an earlier version of this article.

The regulation of 1994

The regulation states that “the monetary policy to be conducted by Norges Bank shall be aimed at maintaining a stable krone exchange rate against European currencies, based on the range of the exchange rate maintained since the krone was floated on 10 December 1992”. The term “to be conducted” implies a time horizon which was short enough not to allow the krone to drift from its anchor to such an extent that it would have a noticeable effect on the country´s competitive position.

The guidelines for monetary policy from 1994 were based on the assumption that price stability could be achieved by binding yourself to an anchor currency of a country where the central bank would pursue its policy with this as its target and was strong enough to be successful in its endeavours. This was also the idea of the ERM within EMS where DEM became the anchor currency for the other participants.

With liberalized capital markets, stability against an anchor currency implies that fluctuations in interest rates will have to follow those of that currency quite closely. This will be conducive to economic stability only if business cycles are reasonably synchronized, as they usually tend to be within the Community, the notable exception being the years after the German unification when, as will be remembered, the ERM was severely unsettled.

Until the early 1970s also the Norwegian business cycle broadly followed that of other European countries, but oil activity and our own counter-cyclical policy based on expected or current oil revenue, produced business cycles in Norway which ran counter to those of the Community countries. Around 1994 Norway and EU were, nevertheless, at roughly the same stage with respect to output gaps, and it was expected that we would return to the old pattern after two decades of oil-determined fluctuations.

But to re-establish full employment, a broader strategy was required, and this was based on the corporative influx in our political life. The strategy was a distribution of responsibilities among decision-making agents. Fiscal policy should smooth economic fluctuations, incomes policy should safeguard (or improve) the competitive position of our industries, while the operational guideline for the conduct of monetary policy should be aimed at maintaining exchange rate stability against European currencies at a level roughly corresponding to that which had in fact been established since the floating on December 10 1992. Particularly the trade unions considered this as essential in order to have a solid benchmark for nominal wage claims which would not endanger the country`s competitive position. No intervention margins were established, however, and the monetary instruments for maintaining this level (the interest rate and interventions) should not be applied at their extreme. If market forces should drive the exchange rate out of position, there should be a gradual return to its initial range. As from 1999 the term "European currencies" has been replaced by the euro.

Within this system, the adjustment to the euro has thus already taken place, and if it had worked according to intentions, no further policy action would have been required.

Implementation of the guidelines and approach to EMU

But contrary to expectations, the Norwegian recovery which in 1994 had just started, grew into a boom, while Continental Europe fell back into a persistent economic stagnation. Through 1995-1996 monetary policy in the Community, led by the Bundesbank, was therefore directed towards stimulating demand by lowering interest rates, while Norges Bank hesitated to follow suit (graph 1). Brighter prospects for future oil revenues than earlier expected also added confidence to the krone.

In order to dampen the demand for kroner, Norges Bank reduced its interest rates by altogether 1 ¼ percentage points. This, however, did not stop the inflow from accelerating, and interventions were discontinued. The krone appreciated by 6-7 percentage points, but fell back during the spring of 1997. The reduction in interest rates had the effect of pouring gas on the fire, and the pressure in the economy intensified. The impact upon wage settlements in 1998 was disastrous. When also oil prices fell dramatically during that year, confidence in the krone evaporated in spite of repeated increases in the interest rate during 1998. After the rate for banks` deposits with the central bank had reached 8 per cent, interventions were again interrupted, and a depreciation followed. This high interest rate was expected to bring a gradual return of the krone to its initial range. The krone also got support from a tighter fiscal budget for 1999 and, probably more important, from higher oil prices due to OPEC supply cuts. In course of the spring 1999 the krone was back to its earlier position. The 3- month money market rate, however, is still (November 1999) some 3 percentage points above the euro rate.

The experience of fluctuations within the range of close to 20 per cent during about two years has proved that the official strategy for economic stability has not lived up to expectations, and in particular that the system of "flexible stability" of the exchange rate produces more flexibility than stability. For the system to survive according to intentions outside support would be required.

With the advent of the euro, the Community appeared to be the most suitable partner for cooperation, like its national central banks had been in the past under the EMS regime. Article 109 in the Treaty appeared to provide a legal basis for EU´s cooperation with third countries in this matter. But to be compatible with the EMU, a central rate for the krone would have to be formally defined in terms of euro, with specified intervention margins and with an obligation for Norges Bank to intervene at their limits. Financial support from the ECB up to an agreed amount in the form of swap credits, where Norway would carry the exchange rate risk, would have to be part of the deal. An agreement would require unanimity in the Council to be signed.

This would bring us back into an exchange rate regime similar to one which broke down in1992, presumably with larger and more usable credit arrangements, but also with a greater danger of becoming the victim of speculation, since the krone would be one of the very few currencies in the industrial world which would lend itself to attack. The Norwegian government did not consider this an acceptable solution.

Early in 1999 there were contacts between the Norwegian authorities and the Commission about the possibilities for cooperation with respect to exchange rate policy, but it resulted in nothing more than polite statements of positions.

Apparently therefore, the replacement of "European currencies" by euro as the numairere against which Norges Bank seeks to stabilize the krone is the closest the Norwegian exchange rate system, as defined in 1994, can be brought to EMU.

A final solution

It is now well established that in markets with liberalized capital transactions, fixed exchange rate regimes have no trustworthy stability to offer. The only way Norway can obtain stability on the basis of the EMU system would be by unilaterally replacing kroner by euro for domestic use, thereby giving euro the position of "legal tender" in our country. Technically it would be feasible to convert all claims and debts at a specified rate, and for Norges Bank to acquire the necessary amount of notes and coins from the ECB and exchange the public´s cash holdings of kroner into euro. That would, once and for all, put an end to speculation against our currency, simply because we wouldn´t have any. The situation would have much in common with the time when gold was our legal tender. Both systems depend on a means of exchange which is acquired by use of revenues or in exchange for assets, rather than being issued by a national monetary authority. The gold standard, as we know, worked quite well.

Politically, however, the situation is now entirely different. The gold standard was international, and we had our own coinage. EMU is part of a system which we, after a long and intense debate, have declined to join. Many who, like myself, were in favour of EU membership, would, on economic grounds argue against taking over a currency which is governed by interests suited to other countries´ economic situation, which is often contrary to ours. Others would take the same position on more emotional grounds.

That Panama is using USD and Montenegro will introduce DEM as their currency, does not make the idea more salable in Norway.

How to read a regulation

The regulation on exchange rate policy from 1994 has, however, lent itself to a more flexible interpretation than was the reason for the untimely reduction of interest rates in 1996 - 97. What is new in this interpretation?

The crucial point is that the time horizon for exchange rate stability has been extended. Already in his first annual speech in February 1999 the governor stated that Norges Bank would be guided by the basic conditions for exchange rate stability over time.

In its recent letter to the Ministry of Finance, the Board of Norges Bank presents these basic conditions, namely that "the instruments of monetary policy must be directed towards bringing inflation down towards the level the ECB is aiming at, simultaneously avoiding a monetary policy that by itself contributes to deflationary recessions, as this may weaken confidence in the krone".

The ECB has, as we know, set as a target that inflation be kept below 2 per cent (or more accurately in the range 0-2 per cent). The term "inflation targeting" has not been used by Norges Bank, but the similarity is striking.

Furthermore, while the managed float which was practiced during the years 1993 - 96 indicated a "level" within a fairly narrow range of 3-5 per cent below the rate before floating, the Board now says that it understands the level as " a broad indication of a central rate against which the krone can fluctuate ".

The new understanding was applied already in January 1999 when Norges Bank´s signal rates were reduced in spite of the krone still being well below the desired level. The rationale behind this move was that the high rate of interest could in the somewhat longer term bring a deflationary setback and thereby endanger stability. The reduced interest rate would still be sufficiently high to reduce the pressure in the economy, and bring inflation down towards the ECB`s target zone. Because everybody, and the Government in particular, welcomed lower interest rates, the question whether Norges Bank´s decisions at this stage were in accordance with the regulation was never raised.

Since then other factors have, as already mentioned, brought the krone back to its earlier level and made further cuts in interest rates possible. Not least for this reason the new understanding of the guidelines has gained general approval. The IMF has recommended the Government to give this understanding of the guidelines for monetary policy its formal approval by reformulating the mandate of the Bank. So far the Government has not found this necessary as there appears to be full agreement between the Ministry of Finance and Norges Bank on how the guidelines are to be understood. The Parliament´s finance committee appears to have approved this understanding. Personally, I believe the Government could only gain by confirming this understanding also to the market.

Contrasting business cycles

The way the guidelines for monetary policy are now understood, they relate themselves to EMU´s aims for monetary policy rather than by its instruments. To the extent that the Community and Norway have opposing business cycles, (chart 2) the application of instruments will tend to contrast.

This contrast was not clearly recognised when Norway applied for membership in 1993, and no formal reservations were taken with regard to membership of EMU. It is also questionable whether that option was available. The contrast that had been until then was not seen as necessarily systemic. It could also be explained by countercyclical policies taken on an ad hoc basis, and it was not assumed that this would apply also to the future. In particular there was no expectation of a strong boom in the domestic economy during the years 1995 – 98, combined with a rather stagnant economy in the Community.

Nor can it now be taken for granted that this pattern will continue. But the fact remains that the structure of the Norwegian economy differs more from the industrial structure of the Community than is the case for any of the member countries. We must expect that some time in the future the strongly fluctuating income stream from oil and gas will have dried up and hopefully been replaced by more stable revenues from financial assets. Closer links to EMU might in that case be considered. In the meantime Norway`s monetary policy, as it is now being formulated, can stand on its own, without any formal attachment to the euro.

The euro in a non-euro economy

But the euro will undoubtedly be the single most important currency in our external transactions. At present about 25 per cent of Mainland Norway`s imports and exports are denominated kroner. With euro being increasingly used within Europe, the krone as an invoicing currency will probably decline in importance. It is also likely that Norwegian shops will be quoting euro prices alongside the krone and take payment in euro.

Our oil exports will probably continue to be denominated in USD, while gas exports, which go mainly to euro countries, might be shifted to euro.

With euro being introduced also in neighbouring countries which are still considering EMU participation, the position of Norway will be felt as somewhat special. But that is a choice we have made in the referendum of 1994. And the experience of other countries with a dominant currency at their border suggests that there is nevertheless a strong preference for the national currency as long as its value is reasonably stable compared to major currencies which could serve as an alternative. Only when there is strong inflation, such as we have seen in South America and Eastern Europe, will it be displaced by currencies like USD and DEM in daily transactions, but most of all as a store for value.

The choice of currency for current payments has some administrative and practical implications, but is of no major importance for the economy as a whole. It is different when it comes to financial assets, i.e. claims upon payments in the future. The real value of such payments is at the core of monetary policy. If such claims, which are now denominated in kroner, to an increasing extent would be in euro, they would also carry euro interest rates, and therefore be unaffected by measures taken by Norges Bank for tightening or easing monetary conditions.

To study this matter further, we shall look at loans and assets separately, keeping in mind that wages will continue to be agreed and paid in kroner and that the public sector will collect taxes, pay its bills and make transfers in kroner. Therefore both households and businesses will depend on krone incomes and will need an income stream in kroner to meet their obligations.

With respect to loans, Norwegian businesses already have an important part of their debt with foreign financial institutions and denominated in foreign currencies, partly to cover their exposure in foreign currency income, and partly because terms have been more favourable.

Also private households have now obtained access to external borrowing, or to borrow from Norwegian financial institutions in foreign currency. But this option is used and offered only to a limited extent and is not well known. Supposedly, this is mainly due to the exchange risk involved, but also because a guarantee from a Norwegian bank will usually be required, and extra fees are to be paid. With more branch offices of banks domiciled in EMU countries and growing familiarity with the new currency, its use by households for financing purposes, may increase. If, however, there is an expectation that the krone will over time depreciate against euro, it may be preferable to borrow in kroner, even if the rate of depreciation is fully compensated by a higher rate of interest. The reason is that our tax system gives a 28 per cent rebate in the form of deductibility of interest payments for assessment of the general income tax. This does of course not apply to repayment of the principal. If the real rate of interest over time is the same for the euro and the krone, the real cost of servicing the loan will be lower, the more the servicing takes the form of interest payments relative to repayment of principal.

With respect to assets, Norwegian households have already taken advantage of the growing opportunities for investing in foreign assets, particularly through mutual funds. Since the market has been concentrated on Norwegian stocks for many years, it is only natural that there is a need for diversification. In the future financial investments will continue to be diversified across countries and regions, but I see no reason why such investments should be more concentrated on the euro than the size of the underlying markets indicate.

Conclusion

Norway is not a member of EU and can therefore not be a member of EMU. For political and constitutional reasons membership is not within the time horizon of current economic planning.

A system of a fixed, but adjustable exchange rate against the euro would be vulnerable to speculative attacks, and the volatility of exchange rates as well as interest rates could easily be excessive. Such risks are augmented by our dependence on two major commodities, oil and gas, the price of which are themselves volatile. An association to EMU under article 109 of the Treaty cannot remedy the problems that are caused by the structure of our economy.

A semi-fixed, semi-floating system (the so-called flexible stability) differs from the fixed rate system only by the central bank´s (or the government´s) commitment to exchange rate stability being less stringent and more uncertain than in a genuine fixed rate system. It carries with it more of the weaknesses of the fixed rate system than of its advantages.

This leaves us with a floating system with a long-term exchange rate stability target, which is almost synonymous to an inflation target, as the only alternative. By adopting such a system, the purpose of monetary policy in Norway will conform, not only to that of EU, but more broadly to its purpose in other developed market economies.

Eurocountries in Norway`s External Relations

	As competitors	Imports	Exports excl. oil and gas
Present eurocountries	44,5	38,0	34.7
Candidates	30,6	34,3	33,5
EU total	**75,1**	**72,3**	**68,2**
North America	12,3	9,2	7,5
Japan	10,8	4,8	3,2
Others	1,8	13,7	21,1
Total	100,0	100,0	100,0

Utkast

Vedlagte artikkel er en bearbeidelse av et foredrag Hermod Skånland holdt på “ARENA Annual Conference” 18. November i år. Foruten å drøfte Norges forhold til euro, gir den en fremstilling av den omlegging av pengepolitikken som har funnet sted i løpet av inneværende år og bakgrunnen for den.

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