Scandinavia: three very different economic tales

The economic research team at Danske Bank looks at market conditions in Norway, Sweden and Denmark, and explores their differing prospects.

International investors tend to regard the Scandinavian countries as one. But, as this article reveals, Scandinavia cannot be viewed as a single entity. For example, Sweden has a well-established inflation regime, Norway has just introduced one, and Denmark has managed to maintain a fixed exchange rate against the euro.

Finland (which is not included in this article) is part of the eurozone. Hence, the national financial markets in Scandinavia react differently to financial news as the reaction patterns of individual central banks differ from one another.

Here, we will review the trends and risks in the Scandinavian markets.

Sweden: dark spots on a golden era

In 1999 and 2000, the story of Sweden was a happy one. Inflation was at a record low. The inflation gap to Germany, which at more than 5 percentage points had broken all records in 1990, had turned largely negative by 1997. In the first quarter of 2000, the 10-year yield spread to Germany moved into negative territory to the great surprise of the international bond market.

However, conditions are not too rosy now because higher inflation and a risk of further disappointing data in the months to come could cause some market unrest.

After Sweden had abandoned its ERM currency target in 1992, the Riksbank – Sweden's central bank – adopted a 2% year-on-year inflation target with a band of plus or minus one percentage point in 1993. Since then, the central bank has built up a credible and transparent monetary policy regime.

The Riksbank sees a balanced picture of inflationary risks: the slowdown in the global economy works in favour of lower future inflation and growth, while the tight labour market and the historically weak krona are working in the opposite direction. The krona's weakness could lead to a further increase in inflation in the short term owing to higher import prices because the effect of the weak currency has not yet been fully reflected in import prices.

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The sharp rise in inflation in April (2.8% year on year) was broadly based. Inflation was fuelled by the rising prices of petrol, housing, food, clothing and electricity. That so many price components rose together suggests that general inflationary pressures are increasing.

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Moreover, the direct effect of the weak krona has yet to be seen, so future key figure releases may disappoint investors in the fixed income markets. We see an asymmetric inflation picture, with risks on the upside.

Despite the increase in inflation, we do not expect Sweden to enter a crisis, as the Riksbank is likely to hike its leading interest rates by 25bp this year to head off inflation. The Riksbank's credibility will have a big effect on inflation expectations and the Swedish krona is likely to strengthen over the summer, so we expect inflation to stabilise once again.

There might be some more negative sentiment on the fixed income market, but in the longer term yield spreads between Swedish and Euroland bonds should narrow as inflation comes down again.

Too early to cut rates in Norway

The Norwegian economy is holding the middle ground. Official interest rates have probably peaked, but it is too early to expect any rate cuts. The high inflation rate and pressures in many parts of the domestic economy led central bank Norges Bank to hike its rates four times, by a total of 1.5%, between April and October last year.

Overall, Norwegian growth has been lacklustre for some time and has remained so into 2001, with growth in the mainland economy of 0.5% in the year to the first quarter of 2001. This could prompt investors to think that inflationary pressures are receding. But they are not, and supply-side constraints are to blame for this.

The labour market is crucial. The tremendous growth of the labour force in the 1990s has almost ground to a halt. On top of this, the output capacity of the economy has been reduced by the holiday reform, which will effectively cut the working year by two days this year and another two days in 2002. With unemployment at about 3.5%, there is simply not a lot of room for growth.

Svein Gjedrem, the central bank governor, has said a number of times that he is concerned about the tight labour market.

Even after giving Norway one of the highest interest rate levels in the OECD region, he found it necessary to warn the public in May that a lack of discipline in next year's wage rounds could force Norges Bank to raise its interest rates again.

His comments after the latest interest rate decision on 16 May indicated, however, that he takes a balanced view of the economy.

Although domestic developments point to an even tighter monetary policy, the marked downturn in the international economy is pulling in the opposite direction. Gjedrem said the next rate change was just as likely to be a hike as a cut.

Norges Bank has repeated this message since before the latest alteration of the monetary policy regime in March, when the bank adopted a full-blown inflation target.

Earlier, the bank had maintained a hybrid regime, in which an implicit inflation target was used as a means of targeting the medium-term exchange rate. The new target of 2.5% annual inflation represents a higher target than the former implicit one of a maximum of 2%. The new target may not be any easier to achieve, however, because the government simultaneously decided to spend more of its oil revenues.

Looking ahead, inflation should decrease from its current level of more than 4% a year. Valued-added tax on food is to be halved on 1 July , and the effects of the VAT rate hike in January will have been exhausted by the end of the year. Moreover, the slowdown in the world economy should help to brake the Norwegian economy further.

The household sector is a main source of uncertainty because households have remained fairly optimistic. Nonetheless, the economic slowdown should take the underlying inflation rate down next year. Therefore, the central bank seems likely to cut its rates in the first half of 2002. Lower inflation should also trigger a significant narrowing of the yield spread between Norwegian and German long-term bonds.

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The Norwegian krone is enjoying strong buying interest on the back of the weak euro, high rates, high oil price, and the positive capital flows associated with the flotation of Statoil.

These flows will have been exhausted by June, after which government buying of foreign currencies for the Petroleum Fund will lead to outflows of Norwegian kroner. With a somewhat stronger euro and lower oil prices, the krone is unlikely to appreciate against its European counterparts.

Denmark tracking euroland

As opposed to Sweden and Norway, Denmark maintains a fixed exchange rate regime against the euro. A proposal to adopt the euro was rejected in a referendum last September, but the fixed exchange rate policy enjoys much popular and parliamentary support.

The financial markets consider Denmark's currency regime as credible, and, since the EMS troubles in 1992-93, the central bank has been able to keep the krone within a narrow band against the Deutschmark and later the euro.

This is reflected in a low and relatively stable yield spread to Germany of 30bp-50bp across the curve. Any interest rate cuts by the ECB (a further 75bp is likely in 2001) will be immediately reflected in Danish interest rates.

The credibility of the fixed exchange rate rests on Denmark's ability to maintain healthy economic fundamentals. Despite the uncertainty surrounding the US economic outlook, and the effects on the rest of the world, there do not appear to be any major risks to the Danish economy.

Last year, GDP growth was primarily driven by exports and investment. Growth in these components should be lower this year because of the global economic slowdown and a rise in the trade-weighted exchange rate.

Instead, consumption is likely to pick up and we are projecting moderate GDP growth of about 2% for 2001 and 2002. The government budget and the current account should remain in surplus, unemployment (currently at 5.4%) should decrease further, and inflation should be moderate at about 2%. ■

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FIGURE 1