The conduct of monetary policy

Svein Gjedrem, Governor of Norges Bank. Introductory statement at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament) on 22 May 2008.

Please note that the text below may differ slightly from the actual presentation. The statement is based on Norges Bank's Annual Report for 2007, Monetary Policy Report 1/08 and the Executive Board's assessments published after the monetary policy meeting on 23 April.

I would like to thank the Chairman of the Committee and also thank the Committee for this opportunity to report on monetary policy in connection with the Storting's deliberations on the Government's Credit Report. My statement is based on the Bank's Annual Report, but is also updated based on the Executive Board's assessments for the period to the previous monetary policy meeting and new information received to date. I also refer to this year's report from Norges Bank Watch, an independent group of experts that evaluates Norges Bank's conduct of monetary policy.

Monetary policy in Norway is oriented towards maintaining low and stable inflation. The target is annual consumer price inflation of close to 2.5 per cent over time. The inflation target provides employers and employees with an anchor for inflation expectations among businesses and households. Inflation stabilised early in the 1990s after falling from a high level in the previous decade. Annual variations in inflation are now substantially smaller than they were in the 1970s and 1980s. Over the past ten years, average inflation has been somewhat lower than, although fairly close to, the target of 2.5 per cent.

Inflation measured by the CPI varies from month to month, primarily as a result of wide fluctuations in electricity prices, but also due to other temporary disturbances.

The rise in the CPI-ATE shows inflation adjusted for one-time effects of tax changes and excluding energy products. Inflation, measured this way, has risen since summer 2006. One disadvantage of this indicator is that it does not only exclude the temporary effects on electricity prices of, for example, changes in the weather; it also excludes more persistent developments in energy prices. Energy prices have risen more than other prices for a fairly long period, leading to an average year-on-year rise in the CPI over the past 5-10 years that has been close to ½ per cent higher than the rise in the CPI-ATE.

Other available measures of underlying inflation also suggest that inflation has moved up. While the year-on-year rise in the CPI-ATE is now 2.4 per cent, other measures of underlying inflation are above 3 per cent.

Recently, inflation has been somewhat higher than our projections from last year. Inflation was broadly in line with expectations through 2007. In 2006, inflation was considerably lower than projected at the beginning of the year. A period of intensified competition seems to have curbed the rise in prices for domestically produced goods and services. Now that inflation has picked up, it is also close to the 2006 projections.

Inflation was particularly low in the years following the turn of the millennium with the stream of ever-cheaper goods from Asia, and solid productivity growth in Norway that resulted in a subdued rise in prices for domestically produced goods and services. Low inflation was addressed by lowering the interest rate. Solid growth in output and demand for goods and services gradually led to prospects for higher inflation. The interest rate has gradually been raised again since summer 2005 to prevent inflation from becoming too high. During 2007, the key policy rate neared what we consider to be a normal level. The key policy rate was raised in seven increments from 3.50 per cent to 5.25 per cent. The interest rate was raised ahead of the curve before inflation approached 2.5 per cent.

Growth in the Norwegian economy has been high and higher than expected since 2003. Growth recovered faster and has been stronger than in the 1980s and 1990s. Growth was unusually high in 2007 for such an advanced phase of the upturn. Annual growth in mainland GDP in the three-year period 2004-2006 averaged more than 4 per cent. In 2007, growth was just over 6 per cent.

Inflation remained low for a long period despite strong growth and increasing capacity utilisation. There are several reasons for this:

First, labour has flowed into Norway from other countries. The opening of the labour market to the new EU countries has provided us with access to a reserve of labour. Initially, workers came to Norway on short-term assignments. They produced in Norway, but their consumption largely took place in their home country, with an attendant increase in the economy's net production capacity. An increasing number of workers subsequently moved to Norway and took up residence here, often accompanied by their families. This still increases production, although the higher number of foreign workers who want to settle in Norway also puts added pressure on domestic resources. Per capita output is not likely to increase as a result of this kind of immigration. Access to foreign labour may nonetheless relieve short-term bottlenecks in some sectors.

In 2007, the population increased by about 55 000, with net immigration coming to 35 000. This is the highest rise in the population ever recorded. This trend seems to have continued so far this year.

Second, businesses in Norway have become more efficient in their operations, resulting in lower costs. It has been profitable to hire more employees despite the high wage level in Norway. The business sector has made use of new technology and businesses have been restructured. The many sweeping reforms of the 1980s and 1990s – the fundamental shift in the Norwegian economy (1) – resulted in more efficient markets. We are now reaping the benefits of the measures implemented then.

Third, prices for goods we import have fallen, while prices for goods we export have risen. Norway's terms of trade have thus improved markedly. Sales of Norwegian exports have been high, and we can import more goods for the goods and services sold by the business sector. Lower import prices have led to low inflation and a substantial increase in employees' real wages. High export prices have resulted in high corporate earnings.

Chart: Capacity utilisation – regional network

Strong economic growth has gradually resulted in high employment and shortages of labour, real capital and other resources. Information from contacts in Norges Bank's regional network indicates that capacity utilisation has remained at a high level over the past year. Other indicators show that capacity utilisation continued to increase through 2007. Higher demand for goods and services combined with a shortage of real resources can easily lead to higher wage and price inflation.

In assessing the inflation outlook, we must therefore have a view concerning the level of available resources in the economy. We attempt to smooth fluctuations in output and employment to some extent. In order to do so, we must also judge whether output and employment are high or low. The output gap reflects our assessment of the level of capacity utilisation. In our projections, we use several methods, a broad range of information and professional judgment. We can never determine the exact level of available resources in the economy. We illustrate the uncertainty by fan charts (2).

Growth in the Norwegian economy has been higher than we assumed a year ago. This reflects a large supply of labour from other countries and high productivity growth, but also increased use of domestic labour and other resources.

It is likely that capacity utilisation will have to decline to prevent inflation from becoming too high.

Unemployment has declined considerably and is now historically low. The increase in employment has been accompanied by a decrease in wage-earners' share of corporate earnings. Developments must be viewed in the context of the many positive factors that have been at work in the business sector. The impact of a number of these factors may now be diminishing. It is not likely that the improvement in Norway's terms of trade will simply continue. Productivity growth seems to be slowing and wage growth is picking up.

Wage-earners' share of value added is therefore rising again, and this will probably curb labour demand ahead.

A number of other factors may also contribute to reducing capacity utilisation even though petroleum investment remains high and public expenditure is growing at a fast pace.

There are signs of a cooling housing market throughout the country. House price inflation peaked about a year ago. For Norway as a whole, house prices have remained approximately unchanged over the past twelve months. There are nevertheless regional differences in house prices. House prices are rising fastest in Rogaland, and falling fastest in Hordaland and the inland regions.

Housing investment gradually slackened through 2007, reflecting higher interest rates, rising inventories of unsold homes and increased construction costs. Several large residential construction projects have now been shelved. We also expect commercial property starts to show a gradual decline.

Developments in capacity utilisation abroad have an impact on capacity utilisation at home.

After several years of strong growth in the world economy, growth is slowing in a number of countries. Growth in the US seems to have come to a halt, and there are fears of a downturn. Growth is also slackening in many western European countries, but emerging economies such as China and India are still growing at a brisk pace. Inflation is picking up in many countries due to rising food and energy prices.

Central bank key rates have been cut in the US and the UK to address deteriorating growth prospects. In the euro area the interest rate has been kept unchanged, while the Swedish central bank has increased its interest rate.

Developments in the world economy will affect the Norwegian economy.

Chart: Spread between money market rates and expected key policy rates

Since end-June 2007, international money and credit markets have been marked by volatility, illiquidity and reduced risk-willingness.

The problems started in the US housing market, but rapidly spread to other financial market segments. Banks, funds and financial undertakings had to bring back on their books loans from bond markets, they started to question the financial position of counterparties and held on to their money. This led to a marked increase in premiums on interbank loans.

When the banks no longer wanted to provide loans to each other, many central banks provided liquidity for an extended term and eased collateral requirements. In periods, Norges Bank has also provided extra liquidity to Norwegian banks. This has reduced swings in the interest rate that banks demand for giving loans to one another.

Norwegian banks rely to a large extent on foreign funding. This is why the increase in money market premiums in the US and Europe quickly fed through to Norwegian interest rates even though Norwegian banks are profitable, retain confidence and have limited loss exposures.

Banks and investors, both in Norway and internationally, now apply a higher premium and higher prices for providing capital for acquisitions, restructuring and investments, and highly leveraged companies have to pay high risk premiums on loans. It has become more difficult to procure financing.

Household credit growth has eased slightly, but remains high. Corporate credit growth is also high. Norges Bank’s bank lending survey indicates a gradual tightening of banks’ credit standards, but so far the effects of tighter credit have not come into evidence.

Chart: Oil price and price indices for Norwegian exports

Developments abroad may also influence the Norwegian economy through reduced trade. It may be more difficult to sell our export goods when growth is declining in other countries, and prices for our products may fall.

Oil prices and other commodity prices have increased appreciably since 2002. The rise in commodity prices has primarily been fuelled by rapid economic growth, particularly in China and other emerging market economies. Conditions are still favourable for shipping and oil and gas, engineering industry, aluminium, ferroalloys and salmon. In the event of a persistent setback in world economic growth, the Norwegian economy will eventually feel the effects through lower exports.

The interest rate differential between Norway and our trading partners has increased. Coupled with solid growth in the Norwegian economy and very high oil prices, this has resulted in an appreciation of the krone. In krone terms, this reduces prices for imported goods and services. A strong krone may also result in lower activity in the business sector and gradually translate into lower wage growth.

The krone exchange rate shows monthly, quarterly and yearly variations. The long-term value of the krone is determined by changes in the terms of trade and permanent differences between domestic and external inflation and productivity. In recent years, the krone has appreciated. Inflation has nevertheless moved up, and is now close to 2.5 per cent. A stronger krone has been needed to keep down inflation.

The real krone exchange rate measures changes in either the price level in Norway relative to other countries or the wage level in Norway relative to other countries. In common currency, the relative domestic price level is now between 5 and 10 per cent higher than the average for the oil age. The wage level measured in common currency is between 15 and 20 per cent higher than the average since 1970.

Norwegian wage costs relative to other countries have reached an unprecedented high level. Nevertheless, there is full employment in Norway. So far, our business sector has been able to live with the high cost level.

But, it may be that we have not yet seen the full impact.

It is primarily through the government budget – growth in general government spending – that the authorities can influence the krone exchange rate and the scale of internationally exposed business.

Our projections for economic developments are presented in Norges Bank's *Monetary Policy Report*. The Report also includes our forecasts for the key policy rate ahead.

Norges Bank's Executive Board has decided that the key policy rate should be in the interval 5 – 6 per cent in the period to the next publication of the *Monetary Policy Report* in June, unless the economy is exposed to major shocks. In accordance with this strategy, the key policy rate was raised by 0.25 percentage point to 5.50 per cent in April.

When inflation is close to 2.5 per cent, the normal interest rate level over time is considered to be between 5 and 6 per cent. The key policy rate is now in this range after a series of incremental increases over the past three years. The interest rate hikes are curbing growth in economic activity. At the same time, increased premiums and uncertainty in financial markets are increasing the cost of corporate and household borrowing. Moreover, the krone is strong. On the whole, monetary policy is probably having a tightening impact. As a result, capacity utilisation may ease ahead so that inflation does not become too high.

The projections are uncertain. New information may reveal that the Norwegian economy is moving on a different path. The projections are based on our assessment of the economic situation, the outlook for other countries, the functioning of the economy and what is needed to reach the inflation target. We must be prepared for a situation where inflation and output deviate from Norges Bank's projections of the most likely paths. This may also lead to a lower or higher key policy rate than envisaged at present.

Allow me to summarise:
Monetary policy now reflects that inflation is close to 2.5 per cent and that there are limited available resources. Capacity utilisation has also been high, at a level needed to bring inflation close to target. Capacity utilisation must now be curbed to prevent inflation from becoming too high. The key policy rate will be set with the aim of keeping inflation close to 2.5 per cent.

Thank you for the opportunity to present these opening remarks.

Footnotes
1) From Jon E. Dølvik, T. Fløtten, G. Hernes and J.M. Hippe (2007): "Hamskifte – Den norske modellen i endring (Fundamental shift – the Norwegian model in flux), p.15, Gyldendal Norsk Forlag A/S. Norwegian only.

2) See Norges Bank Watch 2008 for a critical view on measures on capacity utilisation.