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), 23 May 2005

Please note that the text below may differ slightly from the actual presentation. The statement is based, among other things, on Norges Bank's Annual Report for 2004, Inflation Report 1/2005 and the assessments published after the monetary policy meeting of the Executive Board on 20 April.

I would like to take this opportunity to thank the Storting for again inviting me to appear before this Committee on behalf of Norges Bank in order to report and answer questions on monetary policy in connection with the Storting's deliberations on the Government's Credit Report. The introductory 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 preceding monetary policy meeting.

Flexible inflation targeting

Monetary policy in Norway is oriented towards low and stable inflation. This is the most important contribution monetary policy can make to sound economic developments in the long term.

The inflation target provides enterprises and households with an anchor for future inflation expectations. When there is confidence in the inflation target, monetary policy can contribute to stabilising developments in output and employment.

Norges Bank operates a flexible inflation targeting regime so that variability in inflation and variability in output and employment are given weight when we set the interest rate. Monetary policy influences the economy with long and variable lags. Norges Bank sets the interest rate with a view to stabilising inflation at the target within a reasonable time horizon, normally 1-3 years. The relevant horizon will depend on disturbances to which the economy is exposed and how they affect the path for inflation and the real economy ahead.

We have increased the transparency surrounding the basis for monetary policy decisions in recent years. Norges Bank's statements following its monetary policy meetings, press conferences, the Inflation Report and speeches provide an account of economic developments that are of importance to the Executive Board's assessments and interest rate decisions. All publications are available on our website. Underlying each interest rate decision is a monetary policy strategy drawn up by the Executive Board every four months. The strategy is published directly after it has been approved and at the start of the relevant strategy period.

Devlopments in inflation in 2004 and the first months of 2005

Between December 2002 and March 2004, the key rate was reduced by a total of 5.25 percentage points. The interest rate has since remained at 1.75 per cent. The interest rate decline can be ascribed to a number of factors. In late autumn 2002, inflation started to fall. The inflation projections were also revised down. New information gradually emerged about the outlook for other countries and the Norwegian economy, indicating that inflation might be very low.

Inflation fell markedly from summer 2003, and continued to fall up to spring 2004. Consumer price inflation has subsequently edged up, albeit slowly. Low international interest rates and favourable terms-of-trade developments for Norway have curbed the effects of low interest rates on the krone exchange rate. Higher imports from low-cost countries, competition and more efficient Norwegian production and trading processes have also kept inflation low. One year ago, underlying inflation was close to zero. In April 2005, the year-on-year rise in consumer price inflation adjusted for tax changes and excluding energy products was 0.8 per cent. The rise in prices for domestically produced goods and services has been higher and has picked up over the past year.

Adjusted for the direct effects of the decline in interest rates on house rents and lower rates for day-care places, the rise in prices was 1.0 per cent in April. Alternative measures of inflation also show that underlying inflation has edged up.

Background for the deviations from the inflation target in 2004 and the first months of 2005

Prices for imported consumer goods continued to fall through 2004, but at a slower pace than in the previous year. A weaker krone in 2003 contributed to a deceleration in the fall in prices for clothing and footwear and the decline in prices for audiovisual equipment moderated. The decline has accelerated in the first months of this year, however. The wide variations in prices for some imported consumer goods, in particular footwear and clothing, can have an unexpected impact on consumer price figures from one month to the next.

In 2004, the fall in prices for some services made a strong contribution to keeping inflation low. The fall in airfares and prices for telecom services was particularly pronounced. Intensified competition in these industries has probably reduced operating margins and driven up productivity. In recent months, airfares have picked up again.

In addition, the rise in food prices was very subdued in 2004. New entrants may have increased competition in this industry. These prices have also edged up recently.

Low inflation in the Nordic countries

Inflation has also declined in the other Nordic countries and is relatively low. Common factors have been increased efficiency in distributive trades and service industries and the low rate of increase in prices for imported consumer goods. In highly open economies such as the Nordic countries, we may have to expect somewhat wider variations in inflation than other countries. Euro-area inflation has remained at a higher level even though developments in activity are weak in the euro area.

Stable inflation expectations

Experience may indicate that inflation expectations remain stable even if inflation varies somewhat as long as the interest rate is used actively to moderate variations. Monetary policy cannot fine-tune economic developments, but it can avoid the largest effects when the economy is exposed to disturbances.

Stable inflation expectations can also have a stabilising effect on exchange rate expectations, but growth in public expenditure and prices for Norwegian exports goods also have an influence on exchange rate expectations.

Surveys conducted by TNS Gallup show that inflation exepectations two and five years ahead have remained virtually unchanged over the past year. A selection of economists expect annual inflation to be about 2½ per cent five years ahead and somewhat lower two years ahead.

Norges Bank has sought to counter a fall in inflation expectations. Through the first half of 2004, we stated:

"With the current low level of inflation, it is appropriate to be particularly vigilant as regards developments in consumer prices."[1]

At the monetary policy meetings between September and November, the Executive Board stated that *"particular weight must be given to factors that may delay an increase in inflation."*[2]

Inflation picked up towards the end of the last year. When we became more confident that inflation would not continue to fall, but appeared instead to be picking up, we refrained from repeating this statement.

Output and employment

After slowing around the beginning of 2003, growth in the Norwegian economy picked up markedly through 2004. The recovery has been broad-based. The easing of monetary policy contributed to a sharp rise in private consumption and housing investment. Activity has picked up considerably in service industries and the construction sector. High petroleum investment, the global economic recovery, a weaker krone and lower wage growth contributed to boosting activity in manufacturing industry. Profitability has improved for mainland enterprises.

Mainland fixed investment has also gradually increased. Thus, it may appear that growth in the Norwegian economy has become more self-driven.

Even with a pronounced upswing in output, the increase in the number employed has been limited so far in this cyclical upturn. Measured in terms of the number of person-hours worked, however, employment growth was high last year. Registered unemployment has shown a small decline over the past year. Productivity probably increased more than normally in some industries in the early phase of the recovery. A marked fall in sickness absence may have reduced the need for new employees.

Capacity utilisation in the Norwegian economy has increased, notwithstanding the decline in sickness absence and efficiency gains in the business sector. The output gap is a measure of capacity utilisation in the economy. We interpret a positive output gap to mean that output and capacity utilisation are higher than the level consistent with stable inflation over time.

High domestic interest rates in 2002 and fiscal policy management contributed to substantially lower cost inflation in the private and public sectors over the past two years. Monetary policy easing through 2003 and the beginning of 2004, and low interest rates in 2004 brought capacity utilisation up to a normal level. The Norwegian economy seems to have experienced a fairly soft landing after a period of weak cyclical developments in the international economy and high domestic wage and cost inflation.

There are nevertheless some clouds on the horizon.

In spite of solid growth in the US economy last year and in the first quarter of this year and continued expansion in China, developments in the euro area are sluggish - unemployment remains high and consumer confidence is falling.

There are substantial trade and balance-of-payments imbalances in the world economy. The deficit in the US is matched by surpluses in other countries, particularly in Asia.

Strong demand in the US has underpinned growth in the world economy. Increased imbalances generate uncertainty as to economic developments in many countries. Moreover, high oil prices may curb international growth.

Communication and implementation of monetary policy

Interest rate developments in other countries have been an important factor behind interest-rate setting in Norway. Weak growth in the world economy in autumn 2002 and into 2003 led to lower international interest rates, which remained low for a considerably longer period than expected, as illustrated by actual and expected interest rate developments in the US. Combined with developments in international equity markets and the risk of lower oil supplies, this contributed to a strong krone in 2002. As we reduced interest rates, the krone depreciated considerably. The weakening of the krone came to a halt in winter 2004. Again we started seeing signs of a stronger krone. At the same time, inflation remained low. We therefore placed emphasis on interest rate developments in other countries, and in May 2004 Norges Bank thus stated:

"The inflation outlook in Norway implies that Norway should not be the frontrunner when other countries increase interest rates."[3]

At the monetary policy meetings between September 2004 and February 2005, after key rates had been raised in several other counties, the formulation was changed to the following:*"that we should lag behind other countries in adjusting interest rates to a more normal level."*[4]

In February, we no longer used this formulation. The background for this is that central banks in other countries such as the US, Canada, UK, Australia, New Zealand and Switzerland had raised their key rates. Our closest neighbouring countries - Sweden and the euro-area countries - and Japan have left their key rates unchanged. On average, the key rates among our trading partners have increased by 0.3 percentage point during this business cycle.

After reducing the key rate to 1.75 per cent, we indicated that the uncertainty associated with previous monetary policy easing and the unusually low interest rate implied that we should be cautious with regard to further interest rate reductions. At the same time, the prospect of continued low inflation for a period ahead implied that wide deviations from projected economic developments would be required before the interest rate should be increased. Economic developments in the latter half of 2004 were broadly in line with expectations. The interest rate was left unchanged in line with our statements. We gradually experienced that the monetary policy easing was effective. The uncertainty diminished.

The krone exchange rate

The first signs of the effects of the interest rate cuts appeared in the foreign exchange market. The interest rate differential against other countries narrowed. It became more attractive to borrow and less profitable to invest in the Norwegian krone. The movement in the krone exchange rate was reversed and the krone depreciated through 2003 and into 2004. The depreciation of the krone contributed to restraining the fall in prices for imported goods. The effect occurred gradually.

Higher prices for oil and gas and other exports goods - an improvement in the terms of trade - have increased Norway's disposable income. This may fuel expectations of higher demand for goods and services in financial markets and lead to a deterioration in competitiveness in the bid for economic resources.

If we look far enough ahead, however, we will be able to cover a smaller share of our imports using current petroleum revenues and drawings on the Petroleum Fund. Competitiveness will then have to be improved.[5]

In March 2004, the nominal krone exchange rate was at its weakest level since summer 2001.[6] Since spring 2004, the krone has appreciated. The appreciation of the krone through 2004 was undesirable because it delayed the pick-up in inflation. It also came as somewhat unexpected. The krone was partly influenced by persistenly low international interest rates. In retrospect, it would also appear that high prices for oil and gas and other export goods have contributed to a fairly strong krone.

Higher oil prices entail higher current-account surpluses and higher income for oil companies and the state. Oil companies' additional income and surpluses will largely be channelled abroad. The additional petroleum revenues accruing to the state will essentially be invested abroad through the Government Petroleum Fund. The capital outflows through the oil companies and the Government Petroleum Fund contribute both to keeping down the value of the krone and to stabilising it.

Even though surpluses deriving from petroleum activity are largely invested abroad, more oil money has been put into circulation in the Norwegian economy than earlier. Petroleum investment show a pronounced increase this year. Moreover, government petroleum revenue spending has increased in recent years. There are indications that the oil cash flows into the Norwegian economy may diminish in the period ahead.

Developments in the nominal and real exchange rate over the past year probably reflect an improvement in the terms of trade and an increase in oil cash flows into the Norwegian economy.

After several expensive wage settlements - and a short period of a strong krone - had weakened profitability in the Norwegian business sector, a depreciation of the krone and more moderate wage agreements contributed to restraining the decline in activity and employment. However, costs in the business sector remain high and competitiveness remains measured by relative labour costs are still fairly weak. It is now close to 5 per cent weaker than the average for the period 1970-2004 and about 15 per cent weaker than in the mid-1990s. Manufacturing industry is nevertheless faring well at present thanks to favourable prices and market conditions.

Low real interest rate

The easing of monetary policy has resulted in low real interest rates. Short-term real interest rates have fallen by close to 4 percentage points since the end of 2002.

It would seem that it is not only changes in the real interest rate that have an influence, but also its level. Between December 2002 and March 2004, the interest rate has moved from a high to a low level. The real interest rate is now lower than a real interest rate that implies balance in the economy in the long term - the neutral real interest rate. A real interest rate that is lower than the neutral rate will stimulate activity and fuel pressures in the economy even after the effects of the interest rate fall have been exhausted. Calculations may indicate, on an uncertain basis, that the neutral real interest rate for Norway is between 2½ and 3½ per cent. It has probably fallen somewhat in recent years.

Real post-tax mortgage rates and deposit rates at banks are also very low. Household debt is higher than household deposits in Norway.

The fall in interest rates pushed up house prices. Higher housing wealth provides increased borrowing opportunities that are used. Household debt has risen by around 11-12 per cent over the past year. Household debt is now more than one and a half times as high as disposable income. The accumulation of debt partly reflects structural adaptation over time to a deregulated credit market and partly low interest rates. The higher debt burden has made households more vulnerable. A gradual normalisation of the interest rate will probably contribute to curbing the rise in house prices and gradually bring down debt accumulation.

Conclusion

Two and a half years after we started to lower interest rates it would appear that inflation is moving up, albeit slowly. Inflation is low, but the indices are also influenced by temporary and erratic disturbances. Mainland fixed investment has also shown a gradual increase. In its monetary policy assessments in the previous Inflation Report, the Executive Board indicated that growth in the Norwegian economy has become more self-driven. Capacity utilisation is close to normal and rising. Moreover, the Executive Board has also highlighted several sources of uncertainty such as the considerable trade and balance-of payments imbalances in the world economy.

Footnotes

[1] See Norges Bank press releases of 21 April and 26 May. The press releases following the monetary policy meeting of 17 December 2003, 28 January, 11 March and 1 July 2004 included similar formulations.

[2] See Norges Bank press releases of 22 September and 3 November.

[3] See Norges Bank press release of 26 May 2004.

[4] See press releases following the monetary policy meetings in the period between 22 September and 2 February 2005.

[5] See Akram, Q.F (2003) "Real equilibrium exchange rate for Norway", Norwegian Journal of Economics, no. 2, p. 89-112, and "Oil wealth and real exchange rates: The FEER for Norway ". Working Paper No. 2004/16, Norges Bank, by the same author.

[6] As measured by the import-weighted index I-44.