The economic situation in Norway and abroad

Address by Central Bank Governor Svein Gjedrem. Invited foreign embassy representatives, Norges Bank 27 March 2003.

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Your Excellencies, ladies and gentlemen

Today, I will discuss some of the forces that are shaping the economic outlook in Norway. The weak external environment is affecting the Norwegian economy. War is contributing to increased uncertainty. At the same time, wage developments in Norway have mirrored a tight labour market. In recent years, real wage growth has exceeded productivity growth. The different cycles in Norway and abroad contributed to a substantial strengthening of the krone last year. Competitiveness for mainland businesses has weakened. Since last autumn, however, the outlook for the Norwegian economy has changed. The combination of global stagnation and the high Norwegian cost level is causing job losses and higher unemployment. As this in turn affected the outlook for inflation, monetary policy was eased and the appreciation of the krone has in part been reversed.

Cyclical divergence and the krone exchange rate

The krone exchange rate fluctuates. This is not surprising, as other countries' currencies also vary. The Swedish krona depreciated sharply in 1992. Since then it has remained weak, but has shown wide variations. Pound sterling appreciated by more than 20 per cent between 1996 and 1998, reflecting solid growth in the UK economy from the mid-1990s. A currency that has exhibited wider swings than most is the New Zealand dollar. A sharp appreciation up to the mid-1990s was subsequently reversed. Over the past two years, this currency has moved in tandem with the Norwegian krone.

The effective krone exchange rate is the price of Norwegian currency measured in terms of foreign currency. Developments in other countries are just as important for the krone as developments in the Norwegian economy.

Capital flows freely and flows can change rapidly. This can spill over to exchange rates and interest rates as well as output and employment.

Currency swings are driven by cross-border capital movements. Capital flows were heavily influenced by investor focus on stock market returns until the downturn began. In the US, equity prices almost trebled between 1995 and 2000. Stock markets in other countries followed suit. Capital inflows into the stock market resulted in a strong dollar. However, expectations concerning corporate earnings were higher than later proved to be warranted. When expectations were lowered, equity prices fell. The decline was amplified after the downturn in the global economy deepened as a result of terror and fears of war. Investors sought to avert the risk in the stock market. Demand for bonds increased, resulting in low long-term interest rates.

As equity prices fell, investors started seeking alternative investments. This made the krone market more attractive. The krone appreciated at the same time that foreign stock markets and domestic equity prices fell. Bonds and other interest-bearing securities have been of particular interest.

In recent years, the krone has shadowed the difference between Norwegian and foreign short-term rates. This is why the krone has been strong. In addition, high oil prices have had an influence. The effect of the interest rate differential has been intensified by conditions in capital markets. Investors have been favouring carry trades. The interest rate differential has contributed to a strengthening of the krone.

Monetary policy has since been relaxed. Norges Bank has reduced the key interest rate from 7 to 5.5 per cent since 11 December last year. The krone depreciated from mid-January, partly reflecting expectations of lower interest rates.

Market participants weigh the interest rate differential between Norway and other countries against the likelihood of a depreciation of the krone in the future. Cyclical divergence can cause the krone to overshoot its long-term level in the short term. In mid-March, cost competitiveness in the manufacturing sector was around 10 per cent weaker than the average over the past 30 years. Historically, following such substantial deviations, competitiveness has always returned to the average fairly rapidly.

In the ten years that have passed since the banking and currency crisis in 1992, the Norwegian economy featured a long period of balanced growth. However, towards the end of the upturn, the economy was facing labour shortages, higher wage growth and a sharp increase in household consumption and debt. Interest rates had to be kept high.

While the slowdown abroad started two years ago, the Norwegian economy continued to show a high level of activity. This led to a widening of the interest rate differential against other countries. The main explanation for the wide interest rate differential is not that interest rates are high in Norway, but that interest rates are at a historic low abroad. Interest rates in the US have not been at such a low level since the 1960s.

A further jump in wages in 2002 amplified the imbalances in the economy and fuelled the rise in prices for goods and services produced in Norway. This is why monetary policy in Norway has been tight.

The oil market and the international outlook

In response to heightened uncertainty and fears of war, traditional safe havens for capital, such as the Swiss franc and gold, became increasingly attractive this winter. The Swiss franc appreciated after the events of 11 September 2001 and towards the end of last year. Gold prices moved up sharply after UN Security Council Resolution 1441 was adopted on 8 November last year. Oil prices fell markedly after 11 September 2001, but have since risen.

Prices for other raw materials and staples, such as metals, also seem to be holding up, in spite of low activity in the world economy. These are symptoms of high uncertainty and stock-building in the face of large global risks. However, prices are volatile. Last week, new optimism led to a decline in some of these prices. It is likely that this volatility will continue to reflect perceptions of the developments in Iraq.

Oil prices have been high this winter, in spite of subdued economic activity in major industrial countries. Several factors have kept oil prices high. Fears of war in Iraq increased the uncertainty surrounding global oil supplies. In addition, strike among oil workers in Venezuela reduced oil supply. The strike has now ended, but production in Venezuela is still below pre-strike levels. Commercial stocks of crude oil and refined products were already low when the strike in Venezuela started, especially in the US. The reduced supply of oil reduced stocks further. Combined, these factors exerted considerable upward pressure on oil prices.

Since the outbreak of war in Iraq, oil prices have been volatile. Initially, prices fell sharply. However, uncertainty and fears of a prolonged war have recently offset some of the initial fall.

The present war in Iraq may cause an immediate reduction in oil supply of about 10 per cent of OPEC's total production, including a likely reduction in both Iraq and Kuwait.

Oil supplies are stretched. The major swing supplier - Saudi Arabia - is probably producing close to capacity. During the Gulf War in 1990-91, the oil price peaked at 36 dollars per barrel in October, and remained high throughout the year. When US and allied forces moved into Kuwait on 16 January 1991, oil prices fell sharply. Strategic oil reserves were released to the market at the same time and pushed down prices.

Stocks of crude oil in the US are considerably lower than normal levels. The picture is similar for the OECD as a whole. However, strategic oil reserves are high. In December last year, total strategic oil reserves of OECD countries corresponded to 114 days of import for the net importing OECD countries.

New increases in oil prices would further dampen global economic activity. Major economies such as the US, Germany and France are struggling with stagnation and fears of recession. Substantial tax relief and low interest rates are holding up activity in the US. The Japanese economy has been in a deflationary recession for a long period.

On the other hand, it may well be that the ailing world economy will exert considerable downward pressures on oil prices when the war in Iraq ends. Over the years, a period of low oil prices has tended to follow a downturn in the world economy. This may happen again, at least when production in Iraq is phased into the world oil market.

The US has been the driving force in the world economy. The US economy has historically been very resilient. Growth tends to pick up rapidly after short periods of contraction. Most likely this will prove to be the case this time as well. A positive aspect is that confidence in the financial system has not been impaired.

There is some evidence of a recovery in investment. Investment in both the euro area and the UK fell at a slower pace during 2002. Investment rose slightly in the fourth quarter in the US. However, capacity utilisation in manufacturing remains low in many countries.

In the US, productivity growth and further tax cuts will fuel continued growth in real disposable income. This may provide scope for moderate growth in consumption. On the other hand, the saving ratio of US households will probably need to rise to achieve more sustained growth.

All in all, we still expect global growth to rise gradually to a more normal level, although the recovery will come later than previously expected. However, we cannot exclude the possibility of a fairly long period of stagnation in the global economy. Low interest rates in the US and Europe are a reflection of this risk. The level of investment in the US was high during the expansion, which may have resulted in excess capacity in the business sector. The fall in equity prices is having a negative effect on household wealth. In addition, US household saving is low and low interest rates have induced households to build up debt. The fall in the value of the dollar may make a contribution, but growth in the business sector is still not self-driven and the depreciation of the dollar is reducing other countries' exports. The impetus from the US economy may be weak for several years ahead.

Nor is the rest of the world showing clear signs of an imminent recovery. Japan is dragging down growth in the world economy. The large European economies, in particular Germany, are stagnating. Unemployment is high, but the growth potential appears to be low.

Interest rates in the US and Japan have been reduced to such low levels that there is little room for further stimulus. The monetary policy authorities could use more unorthodox measures. For example, the central bank could purchase massive volumes of long-term bonds - as seen in Japan - or other assets. It is uncertain how effective such measures are. Traditional fiscal policy instruments may also prove to be ineffective when budget deficits are rising sharply. This may fuel expectations of future fiscal tightening and tax increases.

If the world economy continues to stagnate over a longer period, the effects will also spill over to the Norwegian economy. The decline in traditional exports will then persist. Sooner or later, the oil market will also feel the effects of the downturn, and oil prices will decline. If the world economy experiences prolonged stagnation, a lower interest rate and a weaker krone will reduce the effects for Norway. On the other hand, any fiscal slippage will contribute to maintaining a strong krone.

A stagnating global economy has changed the domestic inflation outlook in recent months. It does not appear that interest rates in the US and Europe will increase in the near future. They may even be reduced further before the recovery starts. In Norway, the interest rate has also been reduced and the krone has weakened.

The inflation target and economic stability

The operational target of monetary policy as defined by the Norwegian government is inflation of close to 2.5 per cent over time. The inflation target provides economic agents with an anchor for their decisions concerning saving, investment, budgets and wages.

The responsibility for implementing monetary policy has been delegated to the central bank. This is also the case in other countries. The central bank shall exercise professional judgement within the framework of its mandate. Assessments of economic developments and the basis for interest rate decisions are presented to the public. This makes it possible for others to gain insight into the assumptions and analyses underlying interest rate decisions.

Norges Bank sets the interest rate to achieve the inflation target of 2½ per cent. The inflation target is broadly in line with the targets of our trading partners. It is also an anchor for developments in our exchange rate. The krone fluctuates. We have open trade with other countries and free capital movements. We do not have the instruments to fine-tune the exchange rate. As long as inflation remains low and stable, any substantial deviations in the krone over time will have a considerable impact on activity in business and industry. As a result, the krone will tend to return towards its long-term mean following any substantial deviations.

Wide cyclical differences and differences in wage formation between Norway and other countries have always had an impact on the krone and on competitiveness. The central bank alone cannot, with the instruments at its disposal, steer the exchange rate. This is especially the case during periods of international turmoil and uncertainty, when exchange rate movements tend to be volatile.

The inflation target of 2½ per cent was introduced in March 2001. At the same time, new guidelines for fiscal policy were adopted. The fiscal rule stipulates that the central government budget deficit shall over time be equivalent to the expected real return on the Government Petroleum Fund. The rule is robust to variations in government revenues and provides a stable framework for economic developments. The fiscal rule has been followed, which in itself makes a considerable contribution to stability.

Wage formation and unemployment

High labour costs and global stagnation are leaving a mark on Norway's internationally exposed sector. Many enterprises will not be able to sustain activity given current market conditions and cost levels. Labour costs are also squeezing margins in some private service industries. More enterprises are competing on international markets. Moreover, even if allocations are growing, public entities have limited capacity for increasing employment because wage expenses have risen so sharply.

Unemployment has edged up recently. The current unemployment rate of 4 per cent is more or less on a par with unemployment in 1997. It is also 2 percentage points lower than the average in the 1990s. For manufacturing, the effect of weak profitability has not yet come into full evidence. Unemployment is therefore expected to increase somewhat in the period ahead.

In spite of the high level of wage growth, inflation is low. Conditions have allowed for a gradual narrowing of the interest rate differential between Norway and abroad. How tight monetary policy will be is essentially contingent on how fast wage growth is brought down.

The inflation targets adopted by Norway and our trading partners imply that total wage growth of about 4½ per cent is consistent with little or no change in business sector competitiveness. This is based on the assumption that productivity growth in Norway is around 2 per cent, or about the same as the average for the past 20 years. Both companies and employees can take as a given that inflation will be 2½ per cent over time. This reduces uncertainty and makes it possible for the social partners to disregard brief spells of somewhat lower or somewhat higher inflation.

Inflation does not have to be higher than 2½ per cent in Norway to achieve growth and high employment. The experience of the 1990s demonstrates this. During that period, unemployment fell and growth was strong. Even with major restructuring and changes in industry structure, inflation was close to 2½ per cent.

Growth in real wages is now markedly higher than the underlying growth in productivity. This is why unemployment is rising. Businesses must adjust their workforces to sustain profitability. This leads to a fall in employment, but also continued operations in Norway. The alternative is that companies are not able to adjust their workforces quickly enough. If higher costs cannot be passed on to customers, earnings will fall and the wage share rise. This may lead to closures or relocation of production.

The wage share in Norwegian manufacturing has increased. The situation in service industries is more mixed. Import firms have wider margins. We know that employment in some service industries has fallen. This may indicate that many service enterprises have adjusted their workforces. To some extent, higher costs can more easily be passed on to customers.

This picture is typical of the final phase of an expansion. A tight labour market and the contest for economic resources lead to a sharp increase in real wages. This results in high growth in household income, consumption and housing investment. The propensity to borrow increases and house prices rise sharply. On the other hand, the business sector faces pressures on profitability, a high cost level and declining investment. Commercial property prices fall. At the same time, corporate restructuring brings growth in employment to a halt. When costs reach a high level, employment starts to fall. The period of expansion has then come to an end. The cost level must be adjusted to restore balance in the labour market.

In the manufacturing sector, employment is now declining. In the public sector, where employment growth has been strong the last few years, budgets will only allow a moderate increase in employment in 2003. Overall, employment is projected to fall by ½ per cent in 2003 and remain unchanged in 2004. Labour force participation in Norway is at a record-high level. Consequently, labour force growth may be low in the years ahead. More people may choose to withdraw from the labour market until the situation improves. Some may exit the labour market on retirement schemes.

Nevertheless, we expect unemployment to rise somewhat, especially in manufacturing. The increase through 2002 primarily reflects a rise in unemployment in the service sector. In the manufacturing sector, unemployment remained stable until the end of last year, but has increased substantially in the last few months. More lay-offs and lower confidence point to increased unemployment. However, laxer monetary conditions may improve the balance in the labour market and prevent a further decline in employment.

The economic outlook in Norway

The outlook for the Norwegian economy weakened during last autumn and winter. Overall economic policy remained tight because of the strong krone. Reduced interest rates and the depreciation of the krone since January will stimulate overall demand. Nevertheless, the weak world economy and a high cost level will restrain growth.

In 2002, inflation was 2.3 per cent, which is close to the inflation target, but it has been somewhat lower in recent months. This reflects the strong krone we had last year. The rise in prices for domestically produced goods and services is being influenced by our high wage growth. Wage growth moved up further last year, even in industries where profitability had weakened considerably.

Developments over recent years show that monetary policy is effective and that inflation can be kept at a low and stable rate, even when growth in labour costs is high. However, if developments in the economy are to be satisfactory over time, real wage growth must be adapted to underlying productivity growth.

Norwegian industrial leaders have become increasingly pessimistic in recent months. Sluggish developments in some service industries in Norway have persisted for a longer period than previously assumed. Higher wage growth has also reduced demand for labour in the public sector.

A sharp increase in petroleum investment could provide positive growth impulses to the offshore-related industry. The demand impulses from petroleum investment to the mainland economy may, however, be weaker than has been the case earlier. Imports for construction and installations will pick up substantially from 2002 to 2003. Due to the high cost level in Norway, a growing number of contracts are also being awarded to foreign companies. At the same time, Norwegian shipyards are increasingly using foreign subcontractors in low-cost countries. This is having an impact on the Norwegian engineering industry.

Investment in service sectors has fallen sharply, and is expected to continue to fall. There is also considerable excess capacity in the commercial building market.

Household income growth is expected to slow this year and next, partly as a result of low growth in employment and lower wage growth. The sharp rise in electricity prices has reduced real disposable income. Households' financial position is still solid. Increased uncertainty in the labour market will nevertheless lead to greater caution among households. Households' confidence in their own financial situation and the domestic economy has fallen over the last half year. The interest rate cuts this winter will stimulate household demand. Private consumption may nevertheless move on a weaker path than we assumed last autumn.

Growth in mainland GDP is projected to be lower than trend growth, at 1¼ per cent in 2003. Further ahead, the economic situation will depend on international developments, household expectations, cost levels and monetary conditions.

Despite high wage growth, the year-on-year rise in underlying inflation will most likely range between 1½ per cent and 2 per cent until this summer. Subsequently, inflation will depend on developments in wages, the exchange rate and the interest rate.

In our last Inflation Report, published in March, we presented two alternative paths for the Norwegian economy. In one scenario, the tight monetary policy stance was held unchanged. Inflation then, as shown in this chart, fell below target over the next few years. In the other scenario, monetary policy was relaxed in line with market expectations. Inflation then moved up and was higher than the inflation target.

Based on this analysis, a gradual easing of monetary policy seemed appropriate. Norges Bank will continuously assess developments in the global economy, the Norwegian economy and the krone exchange rate, and set the interest rate with a view to achieving the inflation target.

Thank you for your attention.