The business cycle and monetary policy

Address by Governor Svein Gjedrem at Handelsbanken, Bergen, 17 October 2002

The text below may differ slightly from the actual presentation.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 18 September and on previous speeches.

A year and a half ago, the Government and the Storting adopted new guidelines for economic policy.

Over time, the use of petroleum revenues is to be equivalent to the expected real return on the Government Petroleum Fund, i.e. 4 per cent of the Fund. The use of petroleum revenues is expressed in the structural, non-oil government budget deficit. It is this deficit which, according to the fiscal guideline, should be approximately 4 per cent of the value of the Fund over time. This means that the automatic stabilisers will function, i.e. allowing higher tax revenues to strengthen the budget balance during a boom in the economy, and to have the opposite effect during a downturn.

Norges Bank shall set the key rate with a view to maintaining low and stable inflation. The Government has indicated in the National Budget that monetary policy should be the first to react when the outlook for the economy changes. A situation may nevertheless arise in which an active use of fiscal policy is required, either because capacity utilisation is particularly low, or because pressures in the economy are very strong.

The implementation of monetary policy is delegated to Norges Bank pursuant to the Norges Bank Act and appurtenant regulation. Norges Bank sets the interest rate on the basis of our understanding of the regulation. Our interpretation places emphasis on the Government's rationale behind the regulation, on the intentions as formulated in the first paragraph and on our knowledge about the relationships between the interest rate, the krone exchange rate, output, employment and inflation.

The first sentence in the mandate refers to the value of the krone. Stability in the internal value of the krone implies that inflation must be low and stable. Low and stable inflation fosters economic growth and stability in financial and property markets.

The regulation also states that monetary policy shall be aimed at stability in the external value of the krone. The krone exchange rate fluctuates from day to day, from week to week, and from month to month. We have free international trade and free capital movements. We do not have the instruments for fine-tuning the exchange rate. But when monetary policy is oriented towards low and stable inflation, this will contribute to a stable krone exchange rate over time.

If we take steps to counteract an appreciation of the krone when there are pressures in the economy, we reduce the possibility of keeping inflation at bay and increase the risk of fluctuations in the economy. Maintaining stability in the internal value of the krone must thus take precedence.

The first paragraph of the mandate sets forth its intentions. The last paragraph specifies what Norges Bank is required to do. The inflation target is set at 2½ per cent.

Interest rates influence price inflation through their impact on domestic demand and on the krone exchange rate.

When interest rates rise, it is more profitable to save and more costly to borrow. This has a dampening impact on consumption and investment. Lower demand for goods and services in turn curbs the rise in prices and wages.

Higher interest rates make it more attractive to take krone positions and borrow in foreign currency. As a result, higher interest rates normally lead to an appreciation of the krone. This reduces prices for imported goods. In addition, a strong krone reduces activity and profitability in internationally exposed industries.

It is important to be aware of the relationships between employment, output and inflation. If there is a shortage of labour and other economic resources, a tight monetary policy stance will reduce inflation by affecting aggregate demand. Conversely, when unemployment is high, low interest rates will stimulate demand, which will contribute to stable wages and prices. A monetary policy stance that is oriented towards stabilising inflation will also contribute to stabilising aggregate output and employment.

Monetary policy determines the average inflation level. Output is determined by the supply of labour, capital and technology and by productivity growth. Unemployment is determined in the long run by labour market structures and by wage and income formation. Attempts to increase output beyond the total capacity of the economy will lead to inflation.

What monetary policy can do is to maintain stability without unnecessary fluctuations in output and employment. If wages increase at an unsustainable pace, employment will decline and unemployment will gradually increase. Monetary policy cannot prevent an increase in unemployment that is due to a wage-driven cost shock.

The inflation target provides a framework that ensures that the economy has a nominal anchor.

When the authorities delegate the conduct of monetary policy to the central bank according to a defined mandate, credibility, confidence and consistency will all be strengthened, because the central bank must adhere to this mandate. This enhances the effectiveness of monetary policy, and increases the possibility for monetary policy to contribute to stability in the economy. This is probably the main reason that the conduct of monetary policy has been delegated to the central bank in all the countries that normally figure in our comparisons.

When there is confidence that monetary policy will contribute to low and stable inflation, it can contribute in the short term - under certain conditions - to smoothing fluctuations in output and demand.

In the short term, there is a trade-off between the objectives of inflation stability on the one hand, and output and employment stability on the other. An aggressive monetary policy will rapidly bring inflation to the target. This will cause wide fluctuations in the real economy. The interest rate can also be changed more gradually, which will have less impact on the real economy but cause more pronounced fluctuations in inflation. By influencing inflation over time, we can ensure that an overly aggressive monetary policy does not in itself cause unnecessary disturbances to the economy.

The impact of monetary policy occurs with considerable and variable lags. Our analyses indicate that a substantial share of the effects of an interest rate change will occur within two years. Two years is thus a reasonable time horizon for achieving the inflation target.

It is nevertheless conceivable that in a situation where a high rate of inflation is accompanied by sluggish economic growth, Norges Bank may decide to apply a somewhat longer time horizon than two years to reach the inflation target of 2½ per cent.

The choice of monetary policy time horizon reflects the fact that there are real economic costs associated with bringing inflation rapidly back to the target. This horizon is thus an indirect expression of the trade-off between the objectives of, on the one hand, stable output and employment, and on the other hand, low and stable inflation.

In Norges Bank's last *Inflation Report* of 3 July 2002, consumer price inflation, assuming an unchanged interest rate of 6.5 per cent and a krone exchange rate unchanged from the average rate in the second quarter, was projected at 2¾ per cent two years ahead. At the monetary policy meeting on the same day, the sight deposit rate was raised by 0.5 percentage point, to 7 per cent.

Norges Bank also presented inflation projections based on an exchange rate equal to the average for June and an interest rate of 7 per cent. Since early this summer, the krone has remained in this range.

Consumer prices were slightly higher than projected in June and July, but returned to the level projected in our path in August and September. Adjusted for tax changes and excluding energy products, the year-on-year rise in consumer prices was 2.2 per cent in September 2002.

Activity in the Norwegian economy is high. This year's wage settlement has given households a sharp rise in real income. The oil industry is benefiting from a high oil price. Investment and operating expenses in the petroleum industry are high. There is also growth in public services, some private services and construction.

The outlook for other Norwegian industries is more mixed. The new economy, postal services, media, the consulting business and parts of the transport sector are experiencing difficult times. Some manufacturing sectors are struggling.

The economic outlook abroad is less favourable. This, along with the strong krone, explains the weak foreign demand for Norwegian goods and services.

House prices continue to rise, although at a slower pace than previously. Credit growth this past year has been just over 11 per cent. Medium income households in particular are borrowing heavily. Household financial saving (net financial investment) has dropped to almost zero in the past couple of years. With little slack in the Norwegian economy, strong growth in household consumption will add to the pressures on prices and wages. However, retail sales data for this summer are not consistent with such a rapid growth in household demand. The fall in share prices and in the value of corporate assets may contribute to a slower rise in income for the wealthiest households this year than in previous years. As has so often been the case, figures from different sources may diverge. We have reason to believe that household income is rising substantially. At the same time, the level of financial saving appears to be low. All in all, growth in household demand for goods and services will most likely remain high. There will probably be a shift in demand, however, towards imported goods and services.

For a long time, a stable exchange rate and the level of cost inflation among our trading partners were an anchor for wage determination in Norway. Since 1998, however, the rise in labour costs in Norway has been around 2 percentage points higher than that of our trading partners. High wage growth, combined with the global downturn and a strong krone, is having a severe impact on manufacturing.

The outlook suggests that cumulative wage growth in Norway will be a good 15 per cent higher than in other countries from 1998 to 2003. The krone is now about 9 per cent stronger than the average for the 1990s. The appreciation of the krone is probably reversible, but the loss of competitiveness and jobs caused by the high level of domestic wage growth is difficult to recoup.

Developments in the interest rate differential between Norway and other countries have contributed to strengthening the krone. The interest rate differential reflects high growth in aggregate demand and high wage growth. There is a relationship between wage growth, interest rate expectations and the krone exchange rate. The appreciation of the krone is dampening inflation and is also reducing profitability and employment in the internationally exposed sector.

The recent appreciation of the krone may also be due to developments in the global economy and in international financial markets. Now that share prices have fallen so sharply, investors are looking around for a safe haven. The Norwegian krone, with a relatively high interest rate backed by Norway's oil wealth, may then be an attractive option. Investing in NOK can be perceived as insurance against a global economic contraction that is due to high oil prices and fear of war. However, there is a risk associated with investing in NOK. The Norwegian money market is not very liquid, and should there be developments indicating that it is sensible to withdraw from NOK, the exit from the haven may prove narrow. Hence, investors in NOK take on the considerable risk associated with the relatively poor liquidity in the krone market.

Share prices fell sharply this summer for several reasons, including poorer growth prospects abroad. Developments this summer indicate that the international recovery may be weaker, and come later, than we expected earlier.

The fall in share prices will dampen growth in private consumption and in the rest of the economy. OECD calculations indicate that the effects of the fall in share prices on consumption and GDP are greater in the US than elsewhere.

A sharp fall in share prices will also contribute to dampening activity in the Norwegian economy. The wealth of households that own shares will diminish, and they will reduce their consumption. It will be less attractive to invest in new production capacity. Share price movements may also have a negative impact on business and household expectations.

The stock market decline is inflicting major losses on insurance companies and pension funds, among others. These losses will be passed on to customers. Many municipalities, for example, are recording these losses as a result of the higher payments they are required to make to KLP, the local government pension fund. However, high returns restrained premium income towards the end of the 1990s.

Oil prices rose sharply in 2002. One of the reasons for this is the threat of war in Iraq. Strategic petroleum reserves have been substantially increased in the US, while private sector reserves in the US are low. Futures prices are slightly higher than assumed in the July *Inflation Report*.

If oil prices were USD 10 per barrel higher for a period of one year, global inflation would increase by about 1 per cent and GDP growth slow by about 0.5 per cent. Although the importance of oil prices to the global economy has declined compared with the situation in the 1970s and 1980s, high oil prices over a long period would still have a substantial adverse impact on growth in the world economy.

Growth in the global economy is sluggish, while oil prices are high. This has the effect of curbing growth among our trading partners and weakening markets for the Norwegian export industry. At the same time, it provides a stimulus for some sectors of the Norwegian economy.

Norges Bank's Executive Board left interest rates unchanged at its meeting on 18 September 2002. Norges Bank's key interest rate, the sight deposit rate, therefore remained at 7 per cent. According to Norges Bank's assessment, with an unchanged interest rate, the probability that inflation two years ahead would be higher than 2½ per cent was the same as the probability that it would be lower. It was pointed out that a sharp rise in labour costs is contributing to a relatively high rise in prices for goods and services produced in Norway. At the same time, a persistently strong krone will contribute to restraining prices for imported goods. The strong krone will also have consequences for activity in the internationally exposed sector. Together with prospects for low inflation internationally, the strong krone is the most important force countering the sharp rise in domestic costs.

The central government budget proposal for 2003 is based on a real increase in the use of petroleum revenues of about NOK 2 billion from 2002 to 2003. This implies a structural non-oil deficit of over NOK 30 billion in 2003. Measured as a share of mainland GDP, the structural deficit will increase by only a little more than 0.1 percentage point from 2002 to 2003. This deficit increased by 0.4 percentage point this year. The budget proposal implies a decline in the growth of government budget spending from 2002 to 2003, measured both in real terms and in current prices.

Total direct and indirect tax reductions in 2003 amount to about NOK 10.6 billion. The bulk of these reductions is due to previous decisions, the full effect of which will only be felt in 2003.

The effects of the central government budget for 2003 on developments in the variables that influence monetary policy and interest rate developments will be incorporated in the analysis in *Inflation Report* 3/02, which will be presented on 30 October.

Thank you for your attention.