Current monetary policy issues

Address by Central Bank Governor Svein Gjedrem at the University of Tromsø and at Sparebank1 Nord-Norge, Tromsø, 20 September 2002

Please note that 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.

Monetary policy is conducted by Norges Bank according to guidelines (the Monetary Policy Regulation) laid down by the Government.

The most important monetary policy instrument is the sight deposit rate, the interest rate on banks' deposits with Norges Bank. The site deposit rate forms the floor of the corridor for short-term money market rates and influences banks' lending and deposit rates. Norges Bank's Executive Board assesses the interest rate at a separate meeting every six weeks.

The Bank is required to conduct its activities in accordance with the economic policy guidelines drawn up by the government authorities and with the country's international commitments.

A year and a half ago, the Government and the Storting adopted new guidelines for economic policy. A plan was drawn up for the use of petroleum revenues over the government budget. Government petroleum revenues are placed in the Government Petroleum Fund. The plan is to use the expected real return on the Government Petroleum Fund, i.e. 4 per cent of the Fund, each year. The Government laid down a new operational mandate for monetary policy at the same time. Norges Bank shall set the key rate with a view to maintaining low and stable inflation.

The first sentence in the mandate refers to the value of the krone. Stability in the national 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 international 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.

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

Monetary policy that is oriented towards low and stable inflation 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 curbing inflation and increase the risk of fluctuations in the economy. Maintaining stability in the internal value of the krone must thus take precedence. As long as other countries pursue a policy of low and stable inflation, stability in the international value of the krone is dependent on low and stable inflation in Norway

The implementation of monetary policy has been delegated to Norges Bank. 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 objective 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 interest rate influences price inflation indirectly via domestic demand and via its effect on the 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 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, profitability and the capacity to cover labour costs in the internationally exposed sector.

It is important to be aware of the relationships between employment, output and inflation. If there are shortages in labour and other economic resources, a tight monetary policy stance will reduce inflation by affecting aggregate demand. When monetary policy is aimed at stabilising inflation, it will also contribute to stabilising aggregate output and employment.

If it appears that inflation will be higher than 2½ per cent with unchanged interest rates, the interest rate will be increased. If it appears that inflation will be lower than 2½ per cent with unchanged interest rates, the interest rate will be reduced. This orientation of monetary policy will normally also contribute to stabilising output and employment.

Monetary policy functions 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.

In the long term, monetary policy determines the average level of inflation. Output is determined by the supply of labour, capital and technology and by productivity changes

Monetary policy cannot influence total output and employment in the long term. Attempts to increase output beyond the total capacity of the economy will lead to inflation in the long run.

What monetary policy can do is contribute to the greatest possible stability, without unnecessarily wide fluctuations in output and employment. Overall employment is also influenced by wage formation. If wages increase more than there is a basis for, 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 of this kind.

The phase-in of petroleum revenues into the central government budget shall be equivalent to the expected return on the Petroleum Fund.

Most of the phasing in of petroleum revenues will take place over the next ten years. With a 4 per cent return on the Petroleum Fund, the use of petroleum revenues will rise to almost 5 per cent of mainland GDP in 2010

Fiscal policy influences the distribution of resources in the economy. All else being equal, an increase in the use of petroleum revenues must lead to an increase in the use of resources in public and private services and a reduction in the use of resources in internationally exposed sectors.

The central government budget for 2002 adhered closely to the fiscal guideline. Growth in public spending from last year to this year is estimated at 7 per cent. This is considerably higher than the growth in value-added in the private sector of the mainland economy, which is estimated at around 4 per cent.

Real growth in public consumption is estimated at 1½ per cent. In other words, there will only be moderate growth in the production of public services even if there is a sharp increase in central government allocations.

This is because the cost of producing public services is rising substantially, to some extent reflecting high wage growth in the public sector. There have also been substantial increases in transfers to the household sector through our social security system. As a result, most of the strong growth in central government allocations translates into a sharp rise in household consumption, while growth in public service production remains moderate. This is only to be expected when there is steep increase in public sector allocations in an economy where there are no available resources.

In fiscal policy, emphasis can be placed on smoothing fluctuations in the economy with a view to ensuring appropriate capacity utilisation and low unemployment.

There is an overlap between the tasks that monetary policy and fiscal policy are intended to perform. This makes it natural to raise the issue of whether there is a need to coordinate fiscal and monetary policy decisions.

Several factors may lead to the interplay between monetary and fiscal policy failing to function. Interplay functions well when the decision-making bodies are conscious of how one body's decisions influence the decisions of the others. Unless this fact is recognised, a decision will not produce the intended result. The economy may move in a very undesirable direction, with high interest rates, sluggish economic growth and a deterioration in the state's financial position.

Without coordination, a good result may still be achieved if fiscal policy acts as "leader" and monetary policy as "follower", to use expressions taken from game theory. The fiscal policy authorities can internalise the monetary policy response pattern. The central bank's response pattern must then be known so that the fiscal authorities can take this into account.

The social partners can similarly take any monetary policy response into account when wages are being determined.

The "leader" in this interplay - the social partners - can take the response of the "follower" - Norges Bank - into account. This view is most relevant in centralised wage formation. In decentralised wage formation, monetary policy will instead affect wage growth via market mechanisms, by stabilising aggregate demand. A precondition for interplay that functions well is that Norges Bank's monetary policy is known and remains firm.

The outcome of this year's wage settlement indicates that the social partners have not internalised the monetary policy response pattern. Perhaps one of the stumbling blocks has been the choice of wage settlements at industry level and the large wage increases for employees outside the two largest employer/employee organisations (NHO and LO). The high wage growth also among groups whose wages are determined through individual agreements indicates that the labour market has been tight. However, the rise in salaries for white-collar workers may also reflect weak cost control in enterprises and organisations following a long period of expansion.

With little slack in the Norwegian economy, strong growth in household consumption adds to the pressures on prices and wages.

For a long time, a stable exchange rate and labour costs among our trading partners formed an anchor for wage determination. 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 7 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.

It is worthy of note that wage growth appears to be accelerating in a period with a rise, albeit gentle, in unemployment. This year's wage settlements may indicate that wage formation is changing, in that less emphasis is placed on unemployment when pay increases are agreed.

An unexpected upward shift in labour costs will require an increase in interest rates in order to avoid higher inflation. When wage growth reaches a level that is inconsistent with the inflation target, the result over time will be higher interest rates, lower employment and higher unemployment. There is a relationship between wage growth and interest rates. The lower wage growth is, the lower interest rates will be, and vice versa. The differences between interest rates in various countries reflect to a large extent differences in wage growth. Japan represents the one extreme, with an interest rate of zero and no wage growth. At the other extreme are Iceland and Norway, with high interest rates and high wage growth. The relatively high wage growth in Norway is the result of a tight labour market. In other countries, the situation is different, with sluggish economic growth and abating inflation. As a result, the interest rate is higher in Norway than in other countries.

Over the last two years, the appreciation of the krone has been driven by the wide and increased interest rate differential between Norway and other countries, which reflects the relatively high level of wage growth in Norway.

The interest rate differential reflects high demand growth and high wage growth. There is a relationship between wage growth, interest rate expectations and the krone exchange rate. The appreciation of the krone dampens inflation, and at the same time reduces profitability, employment and the capacity to cover labour costs in the internationally exposed sector.

In the long run, wages must be commensurate with the value added that is generated by workers. Over time, the increase in real wages is therefore determined by developments in labour productivity.

If this historic productivity growth persists, an increase in labour costs of around 4½ per cent in the longer term will be consistent with the inflation target. The outcome of the wage settlements we have observed in recent years is not consistent with this equilibrium.

So far, the effects of high wage growth on price inflation have been counteracted by low imported price inflation. But this will not necessarily continue to be the case.

Real wage growth that is higher than productivity growth results in deteriorating corporate profitability. Firms will hire fewer people and shed labour.

Over the last thirty years, manufacturing has been scaled back in waves, and particularly sharply in the periods 1977 to 1984 and 1987 to 1992. In the years leading up to the periods of contraction, profitability in the manufacturing sector deteriorated. It can take time for such a deterioration to translate into lower output and employment. But when the turnaround does occur, it tends to be swift and hard-hitting.

It now appears that a new period of downscaling is under way. Several factors point to this:

- Manufacturing employment will be reduced in the years ahead, partly as a result of the expected decline in investment in petroleum activities and somewhat higher productivity growth in manufacturing than in other industries. There is also a long-term tendency in other OECD countries towards a decline in manufacturing employment.
- Manufacturing costs have increased sharply since 1998 as a consequence of high wage growth. The appreciation of the krone has exacerbated the deterioration in cost competitiveness.

- Because of the fiscal guideline, the internationally exposed sector is subject to additional pressures, and over time this will lead to restructuring and the transfer of resources from the exposed to the sheltered sector.
- Economic policy response patterns may have undergone some change. Previously, high wage growth and tendencies for the economy to overheat were countered by tightening government budgets. Today, monetary policy shoulders more of the burden. This may sometimes result in a strong krone exchange rate.

The krone exchange rate can move in both directions. It will not appreciate indefinitely. Sustained slower wage growth will be accompanied by a narrower interest rate differential and this may reverse the direction in which the exchange rate is moving.

A declining level of wage growth would provide a strong impetus to the internationally exposed sector. The interest rate could be reduced. This could lead to a depreciation of the krone, and hence a further improvement in earnings and employment.

Developments this summer indicate that the international recovery may be weaker, and come later, than we expected earlier. Equity prices have fallen markedly. The fall in share prices will dampen growth in private consumption and in the rest of the economy.

Growth in the global economy is currently 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, while at the same time providing a stimulus for some sectors of the Norwegian economy.

The public sector has a more dominant role in the three northernmost counties combined than in the rest of Norway, measured in terms of the number of employees in different industries. Industries such as manufacturing and commercial services are represented to a lesser degree in these three counties.

This may indicate that the decline in the internationally exposed sector will not hit Northern Norway as hard as it hits the manufacturing counties of Southern Norway. Among the three northernmost counties, Nordland County nevertheless stands out as one of our most important manufacturing counties.

Demand growth in Norway remains strong. Persistently high wage growth is contributing to a sharp rise in prices for domestically produced goods and services. Household income is growing strongly, and household borrowing is substantial. Measured by value, growth in retail sales is high.

In Norges Bank's last *Inflation Report* of 3 July 2002, consumer price inflation two years ahead, 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. At the monetary policy meeting on the same day, the deposit rate was raised by 0.5 percentage point, to 7 per cent.

We also submitted inflation projections based on an interest rate of 7 per cent and an exchange rate equal to the average for June. This summer the krone has remained around this level.

Consumer prices increased somewhat more than expected in June and July, but returned to the expected level in August. Adjusted for tax changes and excluding energy products, consumer prices rose by 2.3 per cent compared with August 2001.

Norges Bank's Executive Board assessed the interest rate at its monetary policy meeting on 18 September. Interest rates were left unchanged. Norges Bank's key interest rate, the sight deposit rate, therefore remains at 7 per cent. According to Norges Bank's assessment, with an unchanged interest rate, the probability that inflation two years ahead will be higher than 2½ per cent is the same as the probability that it will be lower.

A sharp rise in labour costs is contributing to a relatively high rise in prices for goods and services produced in Norway. A persistently strong krone will contribute to keeping down prices for imported goods. The strong krone will have an impact on activity in the internationally exposed sector. Together with prospects for low inflation internationally, the strong krone is the most important force acting as a counterweight to the sharp rise in domestic costs.