Economic policy challenges

Address by Governor Svein Gjedrem to the Executive Board of the Confederation of Norwegian Business and Industry, 19 September 2002

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. Please note that the text below may differ slightly from the actual presentation.

A year and a half ago, the Government and the Storting adopted new guidelines for economic policy, which call for an annual use of petroleum revenues equivalent to the expected real return on the Government Petroleum Fund. At the same time, the Government issued a new operational mandate for monetary policy. Norges Bank shall set the key rate with a view to maintaining low and stable inflation.

The first sentence in the monetary policy mandate refers to the value of the krone. Stability in the national value of the krone implies that inflation must be low and stable. This is the best contribution monetary policy can make to economic growth and prosperity and is a necessary precondition for stability in the 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 do not have the instruments for fine-tuning the exchange rate.

The first paragraph of the mandate sets forth an objective. The last paragraph specifies what Norges Bank shall 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.

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 curbs 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 is a shortage of labour and other economic resources, a tight monetary policy stance will reduce inflation through its effect on prices for imported goods and on aggregate demand for goods and services and for labour. When monetary policy is aimed at stabilising inflation, it will also contribute to stabilising aggregate output and employment.

If it appears that inflation, with unchanged interest rates, will be higher than 2½ per cent, the interest rate will be increased. If it appears that inflation, with unchanged interest rates, will be lower than 2½ per cent, the interest rate will be reduced.

Monetary policy functions with considerable and variable lags. Therefore, the current level of inflation does not provide an adequate basis for determining the level at which interest rates should be set today. Our analyses indicate that a substantial share of the effects of an interest rate change will occur within two years. Two years is therefore a reasonable time horizon for attaining the inflation target.

It is nevertheless conceivable that in a situation with a high rate of inflation and 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. By influencing inflation over time, monetary policy will not in itself cause unnecessary disturbances in the economy.

Norges Bank has one instrument: the interest rate. Changes in the interest rate have a broad impact. Monetary policy can therefore not be oriented towards stabilising developments only in the internationally exposed sector, as has been advocated. This could easily create considerable imbalances in the Norwegian economy.

The low interest rate policy and devaluations in the 1970s and 1980s are examples of how such a policy can fail. Monetary policy was geared towards preventing a deterioration of competitiveness in manufacturing. The krone was devalued on several occasions. But wage growth accelerated to compensate for higher inflation. The result was a wage and price spiral that hit the entire economy. At the same time, there was a sharp rise in the demand for loans, which created tensions in our financial system in the 1970s and in the 1980s.

Monetary policy can be an effective means of influencing aggregate demand in the economy. However, there is little monetary policy can do to counter disturbances on the output side of the economy. Changes in wage formation, a decline in productivity growth or a sharp rise in prices for important factor inputs must instead be countered by measures to improve the way the economy functions.

Fiscal policy places emphasis 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 reasons 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 result that was planned. 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 of course 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 "follower's" - Norges Bank's - response 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 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 awarded to groups whose wages are determined through individual agreements indicates that the labour market has been tight. The rise in salaries for white-collar workers and managers may also reflect weak cost control in enterprises and organisations following a long period of expansion.

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.

It is the combined wage growth for all groups that influences the inflation outlook. However, substantial wage increases for some groups can trigger wage spirals. Wages for salaried staff in the business sector have exhibited sharp growth. This year, it appears that wage increases will particularly be high in the public sector and in parts of the private service sector.

Over time, growth in real wages must be consistent with growth in labour productivity. With an inflation target of 2½ per cent and trend growth in the economy of 2 per cent, there will be scope for annual nominal wage growth of about 4½ per cent. These figures are consistent with developments in the 1990s. Wage growth averaged 4½ per cent and productivity growth 2 per cent in this decade. This resulted in an inflation rate of 2½ per cent combined with a stable krone exchange rate.

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.

Households are enjoying strong growth in income and are borrowing heavily. Wage growth is high. Financial savings are low. There is strong growth in retail sales measured in current prices. House prices are high. Petroleum investment is also high. On the other hand, we expect to see weak developments in exports and for example in investment in commercial buildings.

The Norwegian krone has appreciated markedly this year. Developments in wage settlements have probably been an important driving force. High wage growth leads to high interest rates, making it attractive to take krone positions. As a result, the Norwegian krone appreciates.

We must be prepared for fluctuations in the krone exchange rate in line with that observed in other countries. There is free trade in goods and services and free capital movements. The krone is floating. This means that economic agents *cannot* assume that the krone will be stable against the euro, against the dollar or against a weighted average of foreign currencies.

The krone does not fluctuate any more or less than other currencies. A large share of petroleum revenues is invested in foreign equities and bonds through the Petroleum Fund. Changes in oil prices influence the size of the Fund, but have little effect on the domestic use of petroleum revenues. The Petroleum Fund thus serves as a buffer against fluctuations in oil prices and shields the krone exchange rate. Nevertheless, we have been prepared for fluctuations in the krone exchange rate on a par with changes 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 clear relationship between wage growth, interest rate expectations and the krone exchange rate. The appreciation of the krone dampens inflation, and at the same time weakens profitability, employment and the capacity to cover labour costs in the internationally exposed sector.

The krone can move in both directions. It will not appreciate indefinitely. Sustained lower wage growth will be accompanied by a narrower interest rate differential and it may reverse movements in the exchange rate.

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

Over the last thirty years, manufacturing has been scaled back in waves. There was substantial downscaling in the years from 1977 to 1984 and 1987 to 1992 in particular. In the years leading up to the periods of contraction, profitability deteriorated in the manufacturing sector. It can take time before such a deterioration translates 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: First, productivity growth is higher in manufacturing than in other industries. This has resulted in a trend decline in the numbers employed in manufacturing in Norway, as it has in other OECD countries.

Second, manufacturing costs have increased sharply since 1998. Up to the summer of 2000, this cost increase was to some extent offset by a weaker krone. The appreciation of the krone has highlighted and exacerbated the deterioration in cost competitiveness. On balance, it appears 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.

Third, as a result of the fiscal guideline, the internationally exposed sector is subject to additional pressure. Over time, the phasing in of petroleum revenues will lead to restructuring and the transfer of resources from the exposed to the sheltered sector.

Fourth, the response patterns in stabilisation policy function in a different way from previously. Under the "Solidarity Alternative", the response pattern consisted of countering labour market pressures and strong wage growth by reducing growth in public spending (or, if appropriate, by strengthening government revenues). This had a beneficial impact on manufacturing industry. Today, monetary policy shoulders more of the burden. This may sometimes result in a strong krone exchange rate.

Fifth, growth in the global economy is sluggish while, at the same time, oil prices are high. The fall in share prices curbs economic growth among our trading partners. Markets for Norway's export industries are stagnating, but at the same time high oil prices are providing a stimulus for some sectors of the Norwegian economy.

Interest rates were assessed by the Executive Board of Norges Bank yesterday. 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 consequences for 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.