The role of the Central Bank

Address by Governor Svein Gjedrem to the Fafo Institute for Labour and Social Research and the Norwegian Power and Democracy Project, Oslo, 6 September 2002

The way in which economic policy is oriented today reflects the experience gained and the lessons learned in the 1970s and 1980s. In Norway, efforts to develop an economy under strong centralised coordination and control culminated in the 1973 proposal[1] to establish an incomes policy council. According to the proposal, the social partners would undertake a commitment through the council to keep negotiated wage increases within specific limits. It was also stipulated that demand management policy should be included as part of incomes policy.

The proposal to establish an incomes policy council was logical. It was the last wall in the building that was constructed after the war. Coordination and control were important key words. Other components were:

- fiscal policy oriented towards full employment
- regulation of credit within limits specified in a separate credit budget
- channelling of loans through the state banks
- regulation of capital movements
- low nominal interest rates stipulated by the government authorities
- a fixed, though adjustable, krone exchange rate
- use of price regulation
- an active business policy through state ownership and state grants and subsidies

The proposal to establish an incomes policy council did not receive support. There was just too much control and coordination. Now, only 30 years later, very little of this system remains. The building was not solid enough. We know from experience that fiscal policy alone cannot ensure a high level of employment. The structure of the labour market and of wage formation is probably of greater importance. The direct regulation of credit, interest rates and capital movements broke down and was phased out in the 1980s. The krone is floating. Price regulation no longer plays a role as a macroeconomic instrument. The scope of business policy has become more general. State ownership in the Norwegian business sector remains extensive, but the management of ownership has been totally revised following the negative experience of companies in Kongsberg, Mo i Rana and Syd-Varanger.

I would like to highlight two factors that have taken on considerable importance for economic policy.

One of these factors is that economic agents look to the future when they make decisions about consumption and investments, wages and prices, and want to take account of economic policy not only as it is today, but also as they expect it to be tomorrow and in the future. This is particularly evident in foreign exchange and financial markets, where exchange and interest rates are influenced when participants shift large amounts partly on the basis of their expectations concerning economic policy and economic developments.

Financial market expectations concerning economic policy are entirely different today from what they were 20-30 years ago.

Behaviour can change from being very rational to herd behaviour. The issues that receive attention, and that govern movements in exchange and interest rates, change. It is thus important that the authorities do not sow doubt, but on the contrary act in a long-term and predictable manner. The authorities must be credible and inspire confidence. There must be a good match between the stated objectives of economic policy and what is actually done to achieve them. This is the most important reason why the implementation of monetary policy has been delegated to the central bank in Norway, as has been the case in other comparable countries. In Norway, the responsibility for interest rate decisions was delegated to Norges Bank in 1986.

The other factor is the special challenges to stabilisation policy posed by petroleum revenues. Norway's export revenues and government revenues can be expected to be very high as long as production remains high, and as long as the global market allows producing countries to extract substantial economic rent. At the same time, we know from experience that revenues may vary sharply from year to year. As a result of the high level of earnings and fluctuations in these revenues, the most important contribution fiscal policy can make to stabilising the Norwegian economy is to provide a sound, long-term plan for the use of petroleum revenues. Attempts to use the central government budget to fine-tune economic activity may, at worst, have a destabilising effect if these attempts are perceived as being a departure from the long-term plan for the phasing in of petroleum revenues. It is necessary to show that fiscal policy can be applied symmetrically in periods of economic expansion and contraction.

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.

Norges Bank's mandate reads as follows:

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

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

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 interest rate influences inflation indirectly via domestic demand for goods and services 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 also 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.

The mandate implies that the interest rate must be adapted to the outlook for the Norwegian economy. 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. This orientation of monetary policy will normally also contribute to stabilising production and employment.

Monetary policy functions with considerable and variable lags. The current inflation rate does not provide sufficient information to determine the level at which interest rates should be set now. 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 weak economic developments, Norges Bank may decide to apply a somewhat longer time horizon than two years to reach the target of 2½ per cent. Nor do we need to be in any hurry to raise the level of inflation in a situation where inflation is very low, while economic activity is high. By influencing inflation over time, monetary policy will not in itself cause unnecessary disturbances in the economy. A precondition for applying a longer time horizon is that financial market participants have strong confidence in low and stable inflation over time, and that wage formation has a nominal anchor.

Flexible inflation targeting provides a framework for the use of monetary policy instruments that both ensures that the economy has a nominal anchor and allows monetary policy to smooth fluctuations in the economy that are due to changes in demand for goods and services. At the same time, the budgetary guidelines state that "...[in fiscal policy] considerable emphasis must be placed on stabilising fluctuations in the economy with a view to ensuring appropriate capacity utilisation and low unemployment."[2] We can see here that there is an overlap between the tasks monetary policy and fiscal policy are intended to perform. This naturally raises the issue of whether there is after all a need to coordinate fiscal and monetary policy decisions.

Is there, for example, a risk of a situation arising where Norges Bank tightens monetary policy to achieve the inflation target, while at the same time the central government authorities increase the use of petroleum revenues (more than implied in the fiscal policy guideline) in order to increase employment and reduce unemployment?

There are various factors that can prevent the interplay between monetary and fiscal policy from functioning.[3] Interplay functions well when the decision-making bodies are conscious of how one body's decisions influence the decisions of the other. 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 deterioration in the state's financial position.[4]

However, even without continuous coordination, a fairly good result may be achieved if fiscal policy acts as "leader" and monetary policy as "follower", to use expressions taken from game theory.[5] The authorities determine fiscal policy knowing how monetary policy will react. Today's flexible inflation targeting establishes a firm framework for monetary policy and provides clear guidelines on how monetary policy is to respond in different situations. The fiscal policy authorities can internalise the monetary policy response pattern. This is only natural, since the mandate for monetary policy was laid down by the Government and the Storting.

In other words, the conditions exist for delegating the interest rate decision, but the central bank's response pattern must be known, so that the fiscal authorities can take this into account.

When the response pattern in monetary policy is known and remains unchanged over time, the social partners can also 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. The current monetary policy guidelines will function well whether wages are determined centrally, locally or individually.

The outcome of this year's wage settlement, and the debate that followed, may indicate that the social partners have not yet internalised the response pattern in monetary policy ensuing from the mandate laid down by the Government and the Storting. Perhaps a stumbling block 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). On the other hand, the choice of settlement type is probably influenced by the participants' assessment of the economic outlook. The high wage growth awarded to 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.

A precondition for interplay that functions well is that monetary policy is known and remains firm. The best thing Norges Bank can do to contribute to good interplay between the various components of economic policy and wage formation is therefore to be transparent about its analyses and assessments of economic developments.

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.

Over time, growth in real wages must be consistent with growth in labour productivity. An inflation target of 2½ per cent and trend productivity growth of around 2 per cent, according to updated national accounts figures, imply annual nominal wage growth of about 4½ per cent. These figures are consistent with developments in the 1990s, when wage growth averaged 4½ per cent. This resulted in inflation of 2½ per cent. The krone exchange rate was stable.

In general, an unexpected upward shift in labour costs will prompt an increase in interest rates in order to avoid higher inflation. With a floating exchange rate and unchanged interest rates, an increase in wage growth of one percentage point will eventually translate into a comparable increase in price inflation, unless this increase is based on higher productivity. The magnitude of the interest rate increase must be adapted to this. First, the nominal interest rate must be increased to maintain the real interest rate. Second, the real interest rate must also be increased in order to prevent inflation from accelerating.

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. Similarly, lower wage growth will normally result in lower interest rates, higher employment and lower 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. 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 wage growth and a high key rate.

High wage growth affects the exposed business sector in two ways. First, it erodes earnings and reduces employment. Second, monetary policy has to be tightened. This leads to an appreciation of the krone, with a further reduction in earnings and employment.

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

Although it is too early to draw final conclusions, there are some indications that wage formation in Norway is changing:

- The social partners do not appear to be placing as much emphasis as previously on developments in wage growth among our trading partners.
- There are also signs that the social partners may be placing less emphasis on the impact on total unemployment when negotiating wages.
- Some features of this year's wage settlement point to a somewhat greater degree of decentralisation in wage formation. An example of this is the municipal sector, where the Federation of Professional Associations will, as from this year, hold local negotiations on pay increases. On the other hand, centrally negotiated pay increases were very high this year.
- In public sector wage settlements, little emphasis appears to have been placed on the assumptions concerning wage growth on which government allocations are based. This has a negative impact on service production in many areas of the public sector.

The experience of this year's wage settlement also indicates that profitability in the internationally exposed sector has been given less emphasis in wage negotiations than earlier. A shortage of labour in more sheltered industries may thus have a greater influence than previously on overall wage growth. Inflation would then be determined by domestic factors to a greater extent than in the past.

The Norwegian economic system has undergone substantial changes over the past ten to twenty years. The model based on detailed control of capital, credit and interest rates and centralised coordination has been abandoned. Less emphasis is placed on having discretionary scope for manoeuvre and on using surprise decisions to influence economic developments. It is recognised that the structure of the labour market and of wage formation has a decisive impact on developments in employment. Monetary policy is delegated in Norway and in comparable countries. The monetary policy guidelines provide a foundation for building credibility and creating confidence in economic policy, thereby making it more effective.

Footnotes

1. Cf. Official Norwegian Report (NOU)1973:36 (price problems)
2. Report 29 (2000-2001) to the Storting: Guidelines for economic policy
3. Various game situations between fiscal and monetary policy are described in the literature. Some of these games are discussed in Kai Leitemo (2000): "Samspillet mellom penge- og finanspolitikken under et underliggende inflasjonsmål for en liten åpen økonomi" (The interplay between fiscal and monetary policy under an underlying inflation target for a small, open economy) in *Norsk Økonomisk Tidsskrift* No. 2/2000, and in Erling Steigum (2000): "Samspillet mellom penge- og finanspolitikken ved et inflasjonsmål" (The interplay between fiscal and monetary policy with an inflation target) in the book *Perspektiver på pengepolitikken* (Perspectives on monetary policy), edited by Jan F. Qvigstad and Øistein Røisland.
4. This is the game theory known as the Cournot-Nash equilibrium.
5. Cf. descriptions in the Stackelberg equilibrium game theory.