Monetary policy and the outlook for the Norwegian economy

Governor Svein Gjedrem. Address at SR-Bank, Stavanger on 5 April 2002

The speech is based on assessments presented in Norges Bank's Inflation Report 1/2002 and in earlier addresses. Please note that the text below may differ slightly from the actual presentation.

The global economy has experienced a slowdown. Growth came to a halt in the US last spring. At the end of last year, the downturn in the US spread to Europe and Asia. In most countries in Europe and in the US, public and private consumption has contributed to sustaining demand, while the decline in investment and inventories has reduced demand.

The US economy is flexible and seldom remains in recession for a long period. There are signs of an early recovery. Equity and commodity prices have returned to levels seen before 11 September. Growth in the US economy picked up again in the fourth quarter of last year and new figures may indicate that the growth rate increased further in the first quarter of 2002.

Consumer confidence in the US is also back to pre-11 September levels, but confidence indicators still show low levels, both in the US and Europe. US enterprises have a high level of debt and are vulnerable. Household wealth has declined. This may lead to an increase in household saving. There is also uncertainty about the speed of the recovery in Europe.

Oil prices plunged towards the end of last year as a result of a reduction in the demand for oil. Since then, the oil price has risen again. Developments are marked by the uncertainty surrounding the prospects for the global economy and the situation in the Middle East.

Due to the slowdown in the global economy, the market potential has weakened for many export industries. Prices for traditional merchandise exports fell by 6 per cent from the second half of 2000 to the second half of 2001, due in part to a decline in salmon and aluminium prices. The volume of traditional merchandise exports contracted early last autumn.

In March, figures from Aetat (the labour authorities) showed that registered unemployment was 3.0 per cent of the labour force, or 0.4 percentage point higher than one year earlier. This increase in unemployment occurred last autumn and reflects mainly a rise in unemployment in the service sector in Eastern Norway.

Last year, the international slowdown, the fall in equity prices and general uncertainty led to a moderate decline in Norwegian household confidence in economic developments. Household confidence has picked up again recently.

Household debt is rising sharply. Debt has risen as a share of disposable income the last two years. Nevertheless, the financial position of the household sector as a whole is still strong. A high and rising saving ratio and substantial increases in house prices over a period of many years have contributed. However, parallel growth in debt and housing wealth constitute a risk. If debt growth continues to rise, household borrowing will amount to more than 1.5 times annual income in 2004.

The high level of new debt increases the interest burden. With the current interest rate level, however, the interest rate burden is considerably lower than in the period from 1987 to 1993.

Enterprise debt has increased substantially in the last six years, from a relatively moderate level of debt at the beginning of the 1990s. Borrowing has increased in particular in mainland enterprises. The sharp rise in debt is closely tied to investment. An increasingly larger share of enterprise debt is used for investments in financial assets. Enterprises must maintain solid earnings in the years ahead in order to service debt.

Banks have borrowed foreign capital to finance the sharp growth in lending. Bank's gross foreign debt has risen from NOK 49 billion in December 1995 to NOK 296 billion in December 2001. Banks' financing has thus become more diversified, but at the same time, uncertainty abroad concerning developments in the Norwegian economy can easily affect Norwegian banks' financing terms. Short-term borrowing abroad in particular can be volatile. The share of short-term foreign financing has been fairly stable in recent years.

Norway's economic policy is based on the guidelines for fiscal and monetary policy. The guideline for fiscal policy states that the use of petroleum revenues over the central government budget shall be equivalent to the expected real return on the Government Petroleum Fund. Monetary policy is oriented towards low and stable inflation. Historically, periods of high inflation have always been followed by a downturn. Low and stable inflation fosters stability and growth in the economy.

Establishing guidelines for economic policy is not new, either in Norway or in other countries. Both fiscal and monetary policy have been based on such rules throughout the post-war period, with the exception of the last half of the 1970s and the first half of the 1980s. Monetary policy has had a clear anchor since 1986.

The inflation target provides an anchor for expectations concerning future inflation and interest rates. The inflation target is set at 2½ per cent. Monetary policy affects the economy with a lag. 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 occurs within two years. Two years is thus a reasonable time horizon for achieving the inflation target.

Economic agents can act on the assumption that the inflation rate will be 2½ per cent. 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. There is symmetry here. It is equally important to avoid an inflation rate that is too low, as it is to avoid an inflation rate that is too high.

Norges Bank presented its last *Inflation Report* on 27 February. We expect price inflation to be about 2½ per cent in two years, if growth in the global economy picks up again as assumed. On the whole, the risk associated with the inflation projection is regarded as balanced.

The tight labour market will probably continue to result in fairly strong growth in labour costs and a relatively sharp rise in prices for domestically produced goods and services. Since 1997, labour costs have increased by between 5 and 7 per cent per year. Annual wage growth is projected at 5 per cent in the period ahead. A subdued rise in prices for imported consumer goods has contributed to reducing overall price inflation. This trend will probably continue for some time ahead. As the global economy recovers, import price inflation will edge up. A rise in labour costs of more than 5 per cent will only be consistent with the inflation target if the krone continues to appreciate. The projections in the *Inflation Report* are based on the technical assumption that the krone exchange rate will remain stable.

Exchange rates between the major currencies fluctuate widely. The US dollar has appreciated by more than 30 per cent since 1995. The German mark (later euro) has depreciated by about the same. The Japanese yen has fluctuated sharply.

Smaller countries have also experienced wide exchange rate fluctuations. The Swedish krona has changed considerably in the last 10 years and is now 10 per cent weaker than in the summer of 2000. The Australian dollar has depreciated by more than 30 per cent since the spring of 1997. Countries whose exports include a large component of raw materials tend to experience considerable volatility in their exchange rate. Australia is one example. Historically, a stable krone exchange rate has been the nominal anchor for the Norwegian economy. Labour costs among trading partners provided an important reference. Now, the inflation target is the nominal anchor.

Fluctuations in commodity prices lead to changes in countries' terms of trade, which measures the ratio of export to import prices. Changes in the terms of trade have an impact on the exchange rate, which in turn dampens the impact on profitability. The exchange rate acts as a buffer. In the 1990s, the fluctuations in Norway's terms of trade were especially wide. Changes in oil prices were an important reason for this. The krone exchange rate has not fluctuated much compared with exchange rates in other countries. The Petroleum Fund acts as a buffer against fluctuations in the oil price because the Fund's capital is invested abroad. This contributes to stabilising the krone exchange rate. Low and stable inflation approximately in line with inflation levels among our trading partners will also contribute over time to stabilising the krone exchange rate.

We must, nevertheless, be prepared for fluctuations in the krone that are in line with the fluctuations observed in other countries. Changes in the global economy can affect the krone exchange rate. The exchange rate may also react to and contribute to curbing the effects of domestic disturbances.

The floating exchange rate is by and large an appropriate instrument for absorbing unforeseen disturbances to the economy. A stronger krone may, for example, prevent domestic demand pressures from translating into higher price inflation. As history and the experience of other countries have taught us, the real economic losses associated with eliminating high inflation and curbing inflation expectations are considerably higher than those associated with a variable nominal exchange rate. If oil prices fall to such a low level that investment on the Norwegian shelf comes to a halt, a weaker krone would contribute to facilitating the restructuring in the business sector and the rest of the Norwegian economy.

The guideline for fiscal policy is expected to contribute to stimulating demand in the Norwegian economy and to sustaining the demand for labour every year for many years to come. Due to an increased use of petroleum revenues, the service industries will need more resources. The contest for labour resources will intensify. To contain inflation, monetary policy must probably be fairly tight in the years ahead.

Over time, the size of the internationally exposed sector will be affected by the portion of the petroleum revenues that is absorbed into the Norwegian economy. Persistent pressure in the economy, when combined with low and stable inflation, may at times translate into a strong krone exchange rate and a decline in competitiveness. In the long run, monetary policy cannot influence overall employment or its distribution across industries. A lower interest rate would have resulted in higher price and cost inflation, which would also have weakened competitiveness. The end result would have been the same for employment and production, but in addition we would have had high inflation. Any appreciation of the krone may, nevertheless, affect the speed at which changes occur in the business sector.

Historically, employment in the internationally exposed sector has declined in waves. The sharpest declines in manufacturing employment were observed in the years from 1977 and 1984 and from 1987 to 1992. Both periods were preceded by a considerable deterioration in cost competitiveness in manufacturing. There is a risk of a new period of decline in manufacturing.

Excessive wage growth, both in manufacturing and other industries, will affect the internationally exposed sector through two channels. First, high wage growth will reduce earnings and employment. Second, the interest rate will be increased and intensify this effect. Manufacturing will, therefore, feel the effects of excessive wage growth to an even greater extent than earlier. As long as wages increase as much as they have the last few years, the business sector's competitiveness will decline, thus contributing to a reduction in employment in goods-producing industries.

Productivity growth varies considerably in different manufacturing sectors. It would appear that productivity in the food and printing and publishing industries has fallen the last few years, reducing overall productivity in manufacturing. Since 1995, labour costs' share of value added has risen by close to 17 percentage points for this industry. Excluding the food and printing and publishing industries, labour costs' share of value added has risen by about 6 percentage points since 1995. Over the last 10 years, labour costs' share has on average remained constant.

Developments for Norwegian enterprises do not have to be negative. Some enterprises could be at the forefront of technological developments and increase efficiency at a faster pace than the relatively high increase in costs in Norway. Many enterprises move large portions of their production abroad. Norwegian manufacturing companies could still be profitable even if the size of the manufacturing sector in the Norwegian economy is reduced.

However, scaling back manufacturing involves a risk. It makes the economy more vulnerable. The growth potential of the economy - the basis for learning, innovation and development - may be impaired when less of the business sector is exposed to intense foreign competition.