Monetary policy and the outlook for the Norwegian economy

Jarle Bergo, Deputy Central Bank Governor. Address at the Capital markets seminar, hosted by Terra-Gruppen AS, Gardermoen, 31 January 2002

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

Summary and charts

The address is based on the assessments presented at the press conference following the monetary policy meeting of Norges Bank's Executive Board on 23 January 2002.

On 29 March 2001, the Stoltenberg Government issued new guidelines for monetary policy and presented guidelines for fiscal policy. The guidelines for fiscal policy imply that the central government budget deficit shall be equivalent over time to the expected real return on the Government Petroleum Fund. The changes in the guidelines for economic policy received broad support in the Storting. The budget for 2002 adhered to these guidelines.

Monetary policy is to be oriented towards low and stable inflation. The inflation target was set at 2½ per cent. In general, direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Low and stable inflation is the best contribution monetary policy can make to growth and prosperity. In the long term, monetary policy has little effect on employment and output. Inflation is a monetary phenomenon. In the last hundred years, we have had three extended periods of inflation - during World War I, during World War II and after the oil price shocks in the 1970s and 1980s, which triggered wage-price spirals. None of these periods will be remembered as being particularly successful economically.

Historically, economic growth has been strong in periods of relatively low inflation and weak in periods of especially high inflation. Inflation poisons the economy.

The interest rate affects inflation through a number of channels. An increase in the interest rate will normally contribute to reducing inflation by curbing demand for goods and services and by strengthening the krone exchange rate against other currencies. An interest rate reduction has the opposite effect. The strength of these effects will depend on the situation prevailing at the time of the interest rate change and how the change is perceived. The effects may also vary over time. Monetary policy affects the economy with a lag. Analyses carried out by Norges Bank indicate that a substantial share of the effects on inflation occurs within two years. Two years is thus a reasonable time horizon for achieving the inflation target of 2½ per cent. If evidence suggests 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.

Inflation in Norway is determined by both domestic and international inflationary impulses. Domestic inflationary impulses are influenced by the state of the Norwegian economy. International inflationary impulses are generated via prices for imported consumer and intermediate goods. These inflationary impulses will be influenced by developments in international commodity and consumer prices and by the exchange rate.

The inflation target provides the framework for monetary policy. Norges Bank's Executive Board makes decisions about changes in the interest rate. The members of the Executive Board are collectively responsible for the Bank's decisions.

The Executive Board meets every three weeks. At every second meeting, the Executive Board discusses monetary policy in depth. Decisions regarding changes in the interest rate will normally be made at these monetary policy meetings. Three times a year, Norges Bank prepares inflation reports in which it presents its projections for inflation and economic developments in the years ahead. The Executive Board discusses the economic outlook at a separate meeting three weeks before the *Inflation Report* is presented. On the basis of preliminary projections for the report, the Executive Board assesses the outlook for inflation two years ahead and the uncertainty surrounding these projections. The following day, the Executive Board summarises its discussions and assesses the consequences for monetary policy for the next four months. This assessment constitutes an important internal reference when the Executive Board later makes a decision regarding the interest rate. It will also provide the basis for our external communication through speeches and the media.

The risk of a deep recession in the world economy appears to have diminished. There is still, however, considerable uncertainty surrounding both the timing and the strength of the recovery.

Last year industrial output declined markedly in all major regions of the world economy. In the US it appears that the decline may be coming to a halt. Developments in Japan are still highly uncertain. In the US, confidence indicators have recently shown some signs of improvement. The decline recorded following the terrorist attacks on 11 September last year has been partly reversed. Nor does it appear that households in the euro area have become more pessimistic in the last few months. However, the indicators suggest that they still consider the economic situation to be fairly negative.

Various institutions' growth forecasts for 2002 were lowered substantially through 2001. Due to sluggish economic developments, many central banks reduced their key rates last year, in some cases quite appreciably. With the exception of Japan, no significant further downward adjustments of growth forecasts have been made in the last few months.

Norges Bank expects international consumer price inflation to be low both this year and in 2003. This will contribute to a low, and in some cases negative, rise in prices for imported consumer goods.

During the autumn of 2001, we saw signs that the international turnaround was also being felt in Norway. Some export industries, travel and tourism were most vulnerable. The oil price fell sharply. Since last autumn the oil price has hovered around USD 18-20 per barrel. The price of oil futures has remained stable at around USD 20 per barrel. This level will still provide solid profitability for many investment projects in the petroleum sector and continued large surpluses on the current account and in government finances.

The krone exchange rate, measured against our most important trading partners, has appreciated by about 7 per cent since the spring of 2000. However, the krone exchange rate is about 2.5 per cent weaker than in 1990 and at the same level as in the mid-1990s.

Traditional merchandise exports remained high in the first half of 2001 but exhibited a weaker trend in the second half of the year. Foreign trade figures for the fourth quarter of 2001 indicate that the decline in export volumes may have come to a halt, although export prices are still falling.

Consumption indicators suggest strong growth in private consumption.

Credit growth has slowed somewhat due to reduced borrowing by enterprises. Household borrowing, on the other hand, has increased further. Developments in debt may also influence financial stability. Although borrowing by enterprises appears to be declining, their debt burden remains high. This reduces enterprises' ability to cope with downturns. The household debt burden is increasing, but the level is low. These developments are due in particular to the housing market, with high turnover and high price rises. Experience shows that private sector debt tends to increase at a particularly fast pace during upturns. Higher asset prices may be a driving force. As a result of keen competition for loan customers, excessive optimism and problems in distinguishing between sound and unsound projects, risk may be underestimated during upturns.

The labour market has few available resources. Registered unemployment has remained steady at about 2½ per cent since the beginning of 1998. Long-term unemployment is low, and spells of unemployment are generally brief. Unemployment has edged up in the last few months, primarily in Eastern Norway, while employment growth has been limited. In the aftermath of the terrorist attack on 11 September last year, the aviation and travel industries reported job cuts. Cutbacks have also been announced in the process industry.

The guidelines for fiscal policy will stimulate activity because petroleum revenues will now be phased into the economy. According to the Government's estimate, the guidelines imply an average increase in the use of petroleum revenues in the central government budget of about 0.4 per cent of mainland GDP each year from 2002 to 2010. The government budget that was approved for 2002 implies that the use of petroleum revenues will increase by 0.6 per cent of mainland GDP from 2001 to 2002.

The guidelines for fiscal policy imply a substantial stimulus each year. The expansionary impetus varies considerably, and is greatest in the first few years. However, an unpredictable and more expansionary fiscal policy than that implied by the guidelines would have resulted in greater uncertainty. The guidelines provide a stable framework that contributes to reducing some of the uncertainty.

Over time, the size of the internationally exposed sector will be affected by the portion of petroleum revenues that is absorbed by the Norwegian economy but will be unaffected by monetary policy. Any appreciation of the krone may, nevertheless, affect the speed at which changes occur in the business sector. To maintain a balance in the Norwegian economy, the phasing in of petroleum revenues must be countered by a monetary policy stance that is tighter than it would otherwise have been. This may be accomplished through a higher interest rate, an appreciation of the krone, or both.

On balance, we expect moderate growth in the mainland economy in the next two years. The projections for GDP growth that were presented in the October 2001 *Inflation Report* were approximately on a par with the growth potential of the economy. Household consumption and public spending are the main forces underpinning growth. Fixed investment and exports are restraining growth. Brisk growth in consumption is resulting in high demand for labour in public and private services. Low international growth and lower petroleum investment are curbing employment growth. A tight labour market is generating continued high growth in labour costs.

An expansionary fiscal policy, growth in private consumption and a continued high rise in labour costs contribute to a high rise in prices for domestically produced goods and services. At the same time, we expect a temporary decline in prices for imported consumer goods. This reflects lower international commodity and producer prices, a slower increase in global consumer prices and a stronger krone exchange rate. As these effects wane, and if global economic growth picks up in line with expectations, import price inflation may reach a more normal level.

If growth in the global economy picks up again as we have assumed, we expect consumer price inflation to be about 2½ per cent in two years. Meanwhile, consumer price inflation may be somewhat lower due to the downturn abroad and the decline in prices for imported goods.

Norges Bank presented its most recent *Inflation Report* in October 2001. In the light of international developments, and other factors, we considered the probability that inflation two years ahead would be lower than 2½ per cent to be greater than the probability that it would be higher. This was the basis for Norges Bank's decision to reduce its key rate by 0.5 percentage point to 6.5 per cent in December. Norges Bank's assessment of the outlook for inflation remained unchanged following the Executive Board's monetary policy meeting on 23 January this year.