Monetary policy and developments in the Norwegian economy

Address by Governor Svein Gjedrem
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Introduction

Economic developments and the outlook for the Norwegian and international economy are marked by uncertainty in the aftermath of the terrorist attacks on the US on 11 September. Since the attacks, signs of recession in the US, Japan and other Asian countries have become steadily clearer while European economies are stagnating. Strong stimulatory measures, particularly in the US, could lead to a pick-up in growth in the course of next year. The risk of a more pronounced and protracted downturn in the world economy has nevertheless increased over the last month.

Until this autumn, the turnaround in the world economy had only limited effects on the Norwegian economy. It now appears clear that Norway will also feel the effects of the slowdown. Many Norwegian companies, in export industries and the travel industry, have been affected by growing caution among households and businesses throughout the world. Moreover, mainland business investment will probably decline.

The global economic slowdown, combined with the appreciation of the Norwegian krone over the last year, is expected to push down imported price inflation and thereby overall inflation. The sharp fall in the value of the Swedish krona will contribute to narrower margins in retail trade and other industries. On the other hand, there are labour shortages in many sectors of the Norwegian economy. This will contribute to sustaining price and wage inflation.

Increased use of petroleum revenues via the central government budget will push up aggregate demand for goods and services and labour over several years. Next year, fiscal policy is expected to generate a stronger stimulus than previously assumed by Norges Bank when setting interest rates. Investment in schools and residential construction could have a marked impact on the construction sector where the labour market is already tight. A substantial increase in household real income will continue to fuel solid growth in private consumption. Even after the fall over the last month, oil prices are at a level that supports large investments in oil and gas production and high expectations as to Norway's future income. The pressure on economic resources would rapidly have fuelled inflation if monetary policy had not contributed to containing demand. In the light of this pressure on economic resources, the interest rate level in Norway will have to remain higher than in most industrial countries.

High growth in labour costs have contributed to weakening corporate profitability over several years. As the krone exchange rate has now returned to the level prevailing in the mid-1990s, the effects of high cost inflation will now become apparent for Norwegian companies that compete at home and abroad. Corporate earnings are declining. The combination of weak global growth, a tight labour market, an expansionary fiscal stance, a high cost level and cost inflation, which must be countered by a fairly tight monetary policy stance, will accelerate and amplify the contraction of our internationally exposed industries.

Guidelines for monetary policy

On 29 March this year, the Stoltenberg Government proposed new guidelines for fiscal policy, which imply a use of petroleum revenues equivalent to the expected real return on Government Petroleum Fund. A clear parliamentary majority supported the Government's long-term strategy for the use of petroleum revenues.

At the same time, the Government issued new guidelines for monetary policy. Monetary policy is to be oriented towards maintaining low and stable inflation. The operational target of monetary policy is consumer price inflation of 2½ per cent.

The guidelines stipulate a number of factors that should not be taken into account in the conduct of monetary policy, including the direct effects on consumer prices of changes in taxes, excise duties or extraordinary disturbances. Monetary policy should not react to such temporary changes in inflation as monetary policy would then expose the economy to unnecessary fluctuations. Monetary policy shall be based on the medium-term inflation outlook.

The new monetary policy guidelines were put into effect immediately, without any significant changes in the conduct of monetary policy. The communication of Norwegian monetary policy has been facilitated with the Government quantifying an inflation target, in line with international practice.

From May 1994, monetary policy was oriented towards maintaining a stable krone exchange rate against European currencies. However, developments since the beginning of 1997 indicated that the exchange rate was no longer an appropriate operational target of monetary policy. Norges Bank therefore placed increasing emphasis on low and stable inflation as a fundamental precondition for exchange rate stability. The best contribution monetary policy could make to a stable krone exchange rate was low and stable inflation in line with the inflation rate of our most important trading partners.

Up to December 1992, Norway had a fixed exchange rate regime. The fixed exchange rate was the nominal anchor for inflation in Norway. The introduction of the fixed exchange rate regime in 1986 followed a longer period, which started in the 1970s, with a weak nominal anchor. This period featured high inflation, accommodated by monetary policy.

Low and stable inflation is the best contribution monetary policy can make to growth and prosperity. Nominal stability is crucial if the business and household sectors are to have confidence in the value of money. Agreements on sales and purchases, loans and interest rates are concluded in nominal terms. Both public and private sector decisions are based on the current value of the krone. The tax system is based on nominal rates.

If there is confidence in the value of money, contracts can be concluded and investments planned without the uncertainty that is associated with high and variable inflation. Moreover, high and variable inflation leads to an unintended redistribution of resources and income. This impairs the basis for growth and prosperity.

With low and stable inflation, prices will function more effectively as an information vehicle in the market. This will help prevent "bubbles" and unsound investments. History tells us that recession normally follows when bubbles burst. Low and stable inflation reduces the risk of the economy itself giving rise to sudden changes and shocks that may lead to cyclical turnarounds.

The implementation of monetary policy

Monetary policy influences the economy with considerable and variable lags. 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 of 2½ per cent.

The effects of interest rate changes are uncertain. In addition, it may be difficult to assess the current situation in the light of the information available. Different indicators may point in different directions, and economic statistics generally become available with a lag. It can thus be argued that a gradualist approach to setting interest rates is appropriate. We will then acquire new knowledge and can adjust the key rate appropriately.

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. There is symmetry here. It is just as important to avoid an inflation rate that is too low, as it is to avoid an inflation rate that is too high.

Norges Bank publishes its inflation projections in the *Inflation Report* three times a year (every four months). The *Inflation Report* includes both a point forecast and an uncertainty interval around the forecast.

Economic developments

Growth forecasts for the global economy have been lowered substantially in recent months. The world economy is now expected to stagnate this autumn. The growth forecast for our trading partners has been halved from December 2000 to August 2001. The tragic events of 11 September will have a further dampening effect on activity in the US, Asia and European economies.

Earlier, a downturn in some regions has often been counteracted by an upswing in other regions. This has dampened the impact on the global economy. The picture is different this time. The downturn appears to be more synchronised than during the downturns in 1975, 1982 and 1991. For the first time since 1974, the cyclical downturns in the US, Japan and Germany are synchronised.

Growth in the US, Europe and Japan is expected to be considerably lower also in 2002 compared with earlier projections [1]. This is because growth is now expected to be sluggish into next year and many analysts now expect the downturn to be more prolonged before recovering.

Industrial output is declining markedly in all major regions in the world economy. The situation has shifted rapidly in the US, following strong growth throughout most of the 1990s. Both private investment and exports have declined in the first half of the year. So far, growth has been buoyed by private consumption. The negative trends in the global economy and the unsettled political situation after the terrorist attacks may have a negative effect on household expectations and thus influence private consumption. Consumer sentiment in the US has become more negative.

European economies are now feeling the effects of the downturn. Channels other than trade have probably had a considerable impact. Expectations may be rapidly influenced.

Weak international economic developments are reflected in share prices. Prices on most stock exchanges have declined since the beginning of the year. Share prices have a tendency to shadow each other in different countries, and the fall in share prices has spread rapidly. The impact of the decline is being felt by many countries simultaneously. Enterprises with global operations may be another channel. Weak profits in one region will result in job cuts and postponement of investments in the entire business. Various economic indicators show a pronounced slowdown in growth in industrial output in Europe.

Oil prices remained high for a long time despite the international downturn, but have fallen since 24 September, hovering just above USD 20 per barrel over the last weeks. Oil price are still at a level that provides scope for large investments in oil and gas production and high expectations about Norway's future income.

At the same time, uncertainty has increased sharply. The oil market prices in an increase in risk both for disruptions in oil supplies and a sharper global downturn.

Many central banks have reduced key interest rates this year. A number of interest rate cuts have been made in the last month. Real interest rates are now low in many countries. The easing of monetary policy will counteract the downturn. In the US and a number of other countries, an expansionary fiscal policy may also contribute to a gradual pick-up in growth.

International developments have increased the uncertainty and downside risks facing many Norwegian export industries. Prices for important export goods such as fish, aluminium and paper have exhibited a substantial fall in recent months. Norwegian manufacturing output has declined somewhat this year, but less than in the US, the euro area and Japan. This reflects differences in industry structure but also the fact that Norwegian manufacturing did not experience the strong upswing at the end of the 1990s and last year. So far this year, oil investment has stabilised at approximately the same level as last year.

Share prices on the Oslo Stock Exchange have also declined in recent months, which has reduced asset values in Norway. In recent years, Norwegian households and enterprises have invested an increasing share of their wealth in international stocks. Pension funds, life insurance companies and households have increased their investments in unit trusts. Shares and securities funds still only account for about 10 per cent of total household wealth. As a result, the share price fall probably has limited direct effects on household consumption. Payments to private and municipal pension funds must still increase. Highly leveraged companies may also find it more difficult to finance fixed investment as a result of the slide in share prices.

Norway is a small, open economy. Consequently, we are highly dependent on the external environment. But often the effects on Norway are different from that of other industrial countries. This reflects differences in industry structure.

The exposure of Norwegian manufacturing in the ICT sector, where the international downturn has been most pronounced, is limited. The processing industry, which accounts for more than 50 per cent of traditional merchandise exports, is the most exposed Norwegian export industry. However, the processing industry is highly capital-intensive and employed only 19 per cent of manufacturing workers last year. As a result, changes in production in this sector seldom have any significant impact on overall employment. This segment includes oil refineries, the chemical and minerals industry, the metals industry and paper and pulp. Norwegian technology companies, which include the engineering industry, are more labour-intensive but produce more for the domestic market than is usually the case in many other countries. Two-thirds of production is supplied to the domestic market and the petroleum sector. In addition, this sector is also characterised by niche technology, with no mass production and few large companies with extensive operations in other countries. These factors may make this sector somewhat less sensitive to international cyclical developments.

Commodity prices have fallen as a result of weak international growth. Metals, especially aluminium, account for a large share of exports from mainland Norway. In the last few months, the price of aluminium has fallen somewhat, but is still high compared with the average price in recent years. Fish prices have also declined recently, partly reflecting higher supply from other countries and a reduction in global demand. The price of fresh salmon is at the same level as in the last half of the 1990s.

Another sector that is gradually feeling the impact of the global economic slowdown is the pulp and paper industry. After a sharp upswing at the beginning of the year, pulp and paper exports have declined in recent months.

The Trøndelag counties are not typical manufacturing counties. A large portion of manufacturing is linked to the food industry, which produces primarily for the domestic market. In addition, there is the timber industry and the engineering industry. Large fish farms are situated along the Trøndelag coast. Business and industry in Trøndelag will probably feel the downturn particularly in the pulp and paper industry and the fish farming industry. I would also assume that retail trade is noticing the competitive pressures from Sweden.

The extraction of the large gas resources in the North Sea off the coast of Central Norway is important for regional business. Developments in oil and gas prices are therefore likely to be of growing importance for the Trøndelag counties.

In Norway, consumer confidence did not weaken over the summer, unlike the situation in the US and many European countries. Over the last months consumer spending on goods has remained fairly stable, after showing some growth at the beginning of the year. According to housing starts statistics, housing investment continued to expand. Regional variations are substantial. South Trøndelag accounts for a substantial share of the contribution to housing starts.

The Norwegian economy is still characterised by high capacity utilisation with a limited supply of labour. Registered unemployment has remained low since the autumn of 1998. As mentioned, however, some industries are feeling the effects of the global economic slowdown. Employment is still on the rise in the public sector and the construction industry. An expansionary central government budget will probably contribute to sustaining employment in these sectors.

There are wide regional variations in unemployment. At the end of September, 3.2 per cent of the labour force in South Trøndelag were unemployed and 3 per cent in North Trøndelag. This is above the national average of 2.6 per cent.

In recent years, consumer price inflation has been higher in Norway than among our trading partners. The year-on-year rise in prices was 2.4 per cent in September. Price developments have been heavily influenced by changes in VAT and some excise duties since the beginning of the year. Developments in electricity prices have also had a considerable impact on the year-on-year rise in consumer prices. However, these effects are only of a temporary nature.

On 10 October this year, Statistics Norway published a consumer price index excluding energy prices and real changes in excise duties. According to this index, underlying inflation has slowed in recent months from 2¾ per cent at the beginning of the year. Measured by this index, the 12-month rise in prices was 2.3 per cent in September. A closer look at the rise in prices for some price components of goods and services included in the index gives a picture of the sources contributing to underlying price inflation. There are two opposing forces at work. A tight labour market has contributed to sustaining cost inflation at a high level over several years. While the rise in prices for Norwegian produced goods and services are pushing up consumer price inflation, stable prices for imported consumer goods are having a dampening effect on the overall rise in prices.

As a result of the tight labour market, labour costs have increased by about 5-6 per cent in Norway in recent years, which is 1½-2 percentage points higher than among trading partners. This is reflected in the higher level of interest rates in Norway. We have had to keep interest rates at a high level to contain inflation. In other countries, the situation is different with low and falling inflation.

The interest rate differential against other countries is probably one reason behind the appreciation of the krone over the last one and a half years, after a comparable depreciation in the preceding years. The effective krone exchange rate measures the krone against 25 of our most important trading partners. According to this index, the krone has appreciated by more than 8 per cent since the spring of 2000. The krone exchange rate is now about 2 per cent weaker than in 1990 and in line with the level prevailing in the mid-1990s.

A stronger krone exchange rate is having a dampening effect on the rise in prices for imported consumer goods and services. In isolation, a strong krone exchange rate implies a weaker competitive position for Norwegian business and industry. With the prevailing strong domestic cost pressures, Norges Bank cannot counter this appreciation without fuelling inflation at the same time.

We no longer have a specific exchange rate target for the krone. The krone is floating. Like many small, open economies such as Sweden, Canada and New Zealand, the value of our national currency will vary.

Changes in the terms of trade are an important source of exchange rate fluctuations. The terms of trade measure the prices for goods and services we export in relation to the prices for those we import.

Commodities account for a substantial share of Norwegian exports. Commodity prices are subject to wide variations. Experience shows that a deterioration in the terms of trade results in a depreciation, and an improvement is accompanied by an appreciation. This is desirable. The exchange rate functions as a stabiliser, a buffer, that cushions the economy against changes in the terms of trade.

Oil and gas are the raw materials that account for the largest share of Norwegian exports. By investing a substantial share of petroleum revenues in foreign equities and bonds through the Petroleum Fund, the effects of short-term fluctuations in oil prices on the domestic use of petroleum revenues are reduced. In the last 20 years, fluctuations in the terms of trade have been three to four times greater for the Norwegian economy including the petroleum sector than for the mainland economy. The Petroleum Fund thus relieves pressure on the krone exchange rate as a buffer.

The phasing in of petroleum revenues into the mainland economy

The bulk of Norway's petroleum wealth will be extracted over a period of 40 years from 1990 to 2030. Oil and gas reserves are part of our national wealth. The transfer of revenues from the sale of oil and gas to the Government Petroleum Fund constitutes a conversion of portions of this wealth, from oil and gas in the seabed to "money in the bank". With a sound management of this capital, future generations can also benefit from the possibilities provided by this wealth.

Swings in oil prices are substantial and oil revenues can vary widely from one year to the next. At the current oil price, a price rise of about USD 5 per barrel would increase the central government surplus by NOK 45 billion. This corresponds to 3 per cent of GDP. A price change of USD 5 is well within the price variations we have witnessed in recent years. With these variations, Norway cannot be dependent on the last krone, nor the last billions of kroner, of petroleum revenues. The fiscal stance must be robust against oil price swings.

The recently approved guidelines for fiscal policy imply that petroleum revenues will be phased into the economy at a pace that is approximately equivalent to the expected real return on the Petroleum Fund.

The guidelines imply that the non-oil deficit will increase in the years ahead. This will generate a stimulus to the Norwegian economy in each year. The central government budget, which was presented on 11 October, is the first budget based on the new guidelines.

The structural, non-oil budget deficit increases by NOK 6 billion compared with last year's budget. The increase is somewhat larger than Norges Bank had previously assumed. Underlying central government spending growth is estimated at 2 per cent from 2001 to 2002. There are elements in the central government budget that may imply a more expansionary fiscal stance. The reduction in accrued taxes is more than double the reduction in recorded taxes. The State Housing Bank's lending limits are increased. The allocation of subsidised loans to municipalities for the maintenance of school buildings will have an expansionary effect. In addition, I would like to mention that the amount of local government debt that will be cancelled is NOK 2.3 billion higher than the amount directly related to the state takeover of hospitals.

Over the last 30 years, the manufacturing sector in Norway has experienced two periods of severe contraction and job losses. The first period was between 1977 and 1984. The other period was in the years of downturn and recession from 1987 to 1992.

Both periods were preceded by a sharp deterioration in cost competitiveness in manufacturing. Experience shows that it can take some time before such a deterioration feeds through to production and employment. But when the turnaround hits, it can hit fast and hard. In 1984, manufacturing employment was about 53 000 - or about 14 per cent - lower than in 1997. From 1987 to 1992, manufacturing employment fell by more than 60 000, or almost 20 per cent.

Fiscal policy influences the business structure through its effect on private and public demand in Norway. Experience shows that if economic policy induces changes in the business structure, a reversal is not easy to achieve. Nor is there any help to be found in allowing inflation to accelerate, as it did in the 1970s and 1980s.

In its submission to the Ministry of Finance of 27 March 2001 on the changes to the guidelines for economic policy, Norges Bank pointed out that the new guidelines for fiscal policy would have consequences for the conditions for the internationally exposed sector:

"Norges Bank would assert that a gradual phasing in of petroleum revenues approximately in step with the expected real return of the Petroleum Fund will, ceteris paribus, contribute to deteriorating conditions for businesses exposed to international competition."

Monetary policy cannot counter such developments in the long run.

[1)] See Consensus Economic Inc. 8 October 2001: Consensus Forecasts