Economic developments and monetary policy

Speech by Central Bank Governor Svein Gjedrem at the meeting of the National Council of the Confederation of Norwegian Commercial and Service Enterprises on 30 May 2001

The assessment of economic developments is essentially based on and in line with Norges Bank's analyses up to the most recent monetary policy meeting on 16 May.

Monetary policy objectives and guidelines

The most important objective of monetary policy is to contribute to low and stable inflation. Economic agents should be fairly certain of the future value of money. High and fluctuating inflation impairs the function of prices as an information vehicle. Agreements pertaining to sales and purchases, loans and interest rates are concluded in nominal krone amounts. The tax system is in nominal rates. When the price level displays wide variations, it is difficult to predict the real content of agreements and budgets. Unexpected swings in the price level can easily lead to fluctuations in the real economy and instability in financial and property markets. The experience of our country and that of others in the 1970s, 1980s and 1990s is that periods of high inflation are followed by downturns with high unemployment. High and variable inflation also leads to an arbitrary redistribution of wealth and income. Hence price stability is the best contribution monetary policy can make to economic growth, welfare and appropriate distribution.

This spring, the Government and the Storting (Norwegian parliament) issued new guidelines for economic policy. The guideline for fiscal policy implies the use of petroleum revenues equivalent to the expected real return on the Government Petroleum Fund, ie an estimated increase in the use of petroleum revenues over the central government budget of about 0.4 per cent of mainland GDP each year up to 2010. A clear majority in the Storting supported the Government's long-term strategy for using petroleum revenues.

At the same time, the guidelines stipulate that the Government shall use the budget to stabilise economic developments. The annual budget resolutions will provide an indication of the emphasis placed on this consideration.

The Norwegian economy and state finances are marked by a high and varying level of petroleum revenues. The basis for determining central government expenditure from one year to the next may thus easily be impaired. If budget outlays are allowed to swing in pace with oil prices, the result may be abrupt shifts and instability in the Norwegian economy. Changes in oil prices will then rapidly influence wage and price expectations, the exchange rate and long-term interest rates. In that case, it would be very demanding to ensure price stability. This would prompt rapid and pronounced changes in short-term interest rates and be accompanied by a higher risk premium on Norwegian kroner, which would lead to a generally higher interest rate level over time. Norges Bank therefore attaches substantial importance to what seems to have become a fairly broad consensus on a long-term anchor for fiscal policy that takes into account possible fluctuations in oil prices from one year to the next. The rule would appear to be credible as well since it is robust in relation to various scenarios for oil prices and oil production.

The Government was of the view that a clearer anchor was required to reinforce monetary policy's role in underpinning stable economic developments. This is why Norges Bank was given a new operational mandate for monetary policy. Norges Bank shall set the key rate with a view to maintaining low and stable inflation. The inflation target is set at 2½ per cent.

The new mandate for monetary policy is in line with international practice. Sweden and the UK have an inflation target. These countries generally have a positive track record, but this may also be ascribable to a situation that was conducive to low inflation after the downturn in many countries in the early 1990s.

In our view, there has been a reasonable degree of confidence in monetary policy over the past decade. Inflation has been low and stable. By quantifying an inflation target, the Government may nevertheless have made it easier to understand Norwegian monetary policy.

With the revision of monetary policy, the Government has also, in our view, recognised low inflation as a benefit in itself. A track record of low inflation over several years has provided Norges Bank with a better basis for implementing monetary policy.

The new guidelines do not imply a significant change in the conduct of monetary policy. The key rate is set on the basis of an overall assessment of the inflation outlook.

Higher interest rates curb demand for goods and services and reduce inflation. Lower interest rates stimulate economic growth. Lower interest rates have the opposite effects. If evidence suggests 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. 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.

A change in interest rates is not expected to have an immediate effect on inflation. 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. Hence, the key rate is set with a view to achieving an inflation rate of 2½ per cent two years ahead.

In some situations where unexpected events lead to an inflation rate that is too high, it may be appropriate to apply a longer time horizon than two years. For example, reducing inflation to 2½ per cent within this time horizon may be associated with unnecessary real economic costs. A precondition for applying a longer time horizon is that there is clear evidence of strong confidence in low and stable inflation over time on the part of economic agents. As experience with setting interest rates using an inflation target is gained, the scope for placing emphasis on stability in the real economy will probably increase.

Low and stable inflation is a necessary precondition for stability in the foreign exchange and financial market and the property market. However, there have been episodes where bubbles have accumulated in these markets, in the form of sharp increases in asset prices in an environment of low inflation. Price increases in property and financial markets can have a considerable impact on wage growth and consumer price inflation after a period. When the bubbles burst, the result may be an economic downturn. Developments in financial markets and property markets can be a source of a more unstable inflation environment. In principle, it would be appropriate to use the interest rate to counter this. In practice, however, it is difficult to assess whether price trends in property and financial markets are sustainable.

When Norges Bank concludes that a change in the key rate is appropriate, the change will in most cases be made gradually. This is because there is normally uncertainty attached to the situation in the economy, disturbances to which the economy may be exposed and how fast an interest rate change influences price inflation. But we will not always take a gradualist approach. A rapid and pronounced change in the interest rate is appropriate if, for example, heightening turbulence in financial markets or a cost-push shock resulting from negotiations indicates that confidence in monetary policy is in jeopardy.

Norges Bank analyses the inflation outlook in its *Inflation Report,* which is published three times a year. Further assessments are presented every sixth week in connection with the Executive Board's monetary policy meetings. It is, as mentioned, the inflation outlook two years ahead that determines the interest rate set by Norges Bank. If special circumstances prompt Norges Bank to apply a different time horizon, the Bank will provide an assessment of this. The same applies should special emphasis be placed on developments in financial markets and property markets.

Today's inflation rate is partly the result of the interest rate that was set one to two years ago. Current inflation figures do not provide an adequate basis for determining the level at which interest rates should be set today. Monthly figures for the consumer price index are also influenced by random and temporary factors that have little impact on developments in inflation over time. Precipitation levels have an effect on electricity prices. Changes in indirect taxes have an immediate impact on the consumer price index. The direct effects of these factors on inflation are exhausted after a year. Hence these factors do not have any implications for the interest rate, which is normally set with a view to maintaining inflation at 2½ per cent two years ahead.

However, it is still interesting to adjust monthly inflation figures for temporary effects to determine whether developments are broadly in line with our projections. This is why Norges Bank presents figures for consumer price inflation where the effects of some temporary factors are excluded. However, the automatic adjustment of inflation figures for direct effects of one-off factors can also be associated with pitfalls. Higher indirect taxes and electricity prices can be a source of accelerating inflation via spillover effects on other prices and wages.

The mandate for monetary policy with an inflation target provides a sound basis for assessing Norges Bank's interest rate setting. Inflation at one point in time, adjusted for certain temporary effects, provides a measure of whether interest rate setting was appropriate. Market participants and others can assess the quality in the inflation reports and analyses published by the Bank, and whether our analyses are consistent with our interest rate setting. The uncertainty associated with economic developments and inflation, as observed since the mid-1990s, may indicate that we normally reach the inflation target within an interval of +/- 1 percentage point.

The Government has assigned a task to Norges Bank. Norges Bank uses its professional judgement in a delimited area. The results of our decisions can be measured. Hence the government authorities can evaluate our performance.

The interest rate differential against other countries has widened

Central banks in several countries have reduced interest rates earlier this year with a view to countering an economic turnaround. The Federal Reserve has cut the federal funds target rate by a total of 2½ percentage points since the beginning of the year. The Bank of England and the European Central Bank have recently cut rates. There is a also a tendency towards a more expansionary fiscal stance in many countries. In the US, fiscal policy has become somewhat more expansionary after many years of relatively tight budgets. Many European countries have also taken a pause in the consolidation of state finances.

Norges Bank increased the sight deposit rate - which is our key rate - by a total of 1½ percentage points last year. So far this year, the key rate has remained unchanged. As a result, the difference between short-term rates in Norway and other countries has increased. Money market rates are about 3 percentage points higher than among our trading partners. Money market rates are 3½ percentage points lower in Sweden than in Norway.

The wider interest rate differential implies, in isolation, a somewhat tighter monetary policy. The krone becomes a more attractive investment currency, and this may have contributed to strengthening the krone. Investments in the NOK market are now generating a return of 7 per cent. A stronger krone reduces the cost of imported goods and services for enterprises and households. Imported inflation is lower. So far this year, the import-weighted krone exchange rate has appreciated by about 3 per cent.

Substantial uncertainty surrounding international economic developments

There is considerable uncertainty attached to international economic developments.

In the US, industrial output and retail sales have weakened markedly over the last three months. Between March and April employment declined by more than 200 000. GDP growth slowed from an annualised rate of a good 5 per cent in the first half of 2000 to about 1 per cent in the fourth quarter of last year and the first quarter of 2001.

US equities, as measured for example by the Dow Jones index, declined markedly through 2000 and in the first quarter of this year. Stock markets in other countries also fell during this period. Equity prices have picked up again since the beginning of April, however. In addition, industrial commodity prices and oil prices have risen over the last month. Moreover, long-term interest rates have increased. These developments may indicate that many operators in financial markets and commodity markets have again become somewhat more optimistic about the prospects ahead.

Household and business confidence also deteriorated through the latter half of last year and early this year, but has remained steady over the last two to three months, as illustrated by the confidence indicators in this chart.

There is substantial uncertainty associated with developments in Japan. Industrial output and exports have declined. The financial sector is struggling in the face of large losses and poor performance, and the general price level is falling.

In the euro area the picture is mixed. Growth is solid in countries like France, Finland and Ireland. Germany has a large internationally exposed industrial sector, which is feeling the effects of the slowdown in growth in the US and Asia. In a survey[1] , growth forecasts for Germany have been revised downwards this year from 3 per cent a few months ago to a good 2 per cent. Economic growth prospects for Sweden and the UK are also weaker than a few months ago.

However, the easing of monetary and fiscal policy in many countries should contribute to a pick-up in growth and reduce the risk of a pronounced international downturn.

The Norwegian economy will be particularly hard hit by an international downturn if this translates into a sharp fall in oil prices and other commodity prices that are important for Norwegian exports. This would lead to lower export revenues and slower growth. Employment would also be affected. An international downturn would also lead to lower prices for imported goods and services and thereby reduce domestic inflation. If other Nordic countries are negatively affected, this will have an impact on the supply of labour in Norway since the Nordic labour market has become increasingly integrated.

Continued pressures in the Norwegian economy

Available labour resources are limited in the Norwegian economy. The labour force participation rate is high. Vacancies are numerous, particularly in the health sector, schools and the construction industry due to a shortage of teachers, nurses, dentists and construction workers. Extensive use of disability and sickness benefits is limiting the supply of labour. Reforms such as contractual pension schemes, which were stepped up through the 1990s, cash allowances for families with small children and an increased number of vacation days this year and next also contribute to reducing the effective labour supply.

The country as a whole is experiencing labour shortages, but the differences between regions and industries are considerable. In Eastern Norway, where service industries are very important, unemployment has declined the last year. From 1998 to 2000 alone, employment in private services rose by 26 000 nationwide. In Southern and Western Norway, unemployment rose last year, largely reflecting the decline in manufacturing employment since the beginning of 1999. Unemployment has declined again recently.

Employment in the public sector has also increased markedly in recent years. Over the last 30 years, the public sector and private services have laid claim to an increasing share of labour resources in Norway, a trend that will probably continue.

The tight labour market reflects a high activity level in the Norwegian economy. The mainland economy is experiencing an upturn, but growth is low. Growth in private consumption has been moderate the last year following many years of high consumption growth in the 1990s. House prices have increased markedly the last decade. Inflation-adjusted house prices are now more than 10 per cent higher than at the highest level in the 1980s. Growth in lending to the household and enterprise sectors remains high.

Since 1997, price inflation has been higher in Norway than among our trading partners. Price inflation has accelerated the last year, also when we disregard the increase in petrol prices and indirect taxes since the beginning of this year. The year-on-year rise in overall consumer prices was 3.8 per cent in April 2001. Excluding indirect taxes, electricity and petrol prices, the year-on-year rise in prices was about 2 ½ per cent in April of this year.

Higher price inflation in Norway is primarily due to a tight labour market that has persisted over many years, fuelling strong growth in wages and labour costs. In the light of higher price and cost inflation in Norway than in other countries, it has been appropriate to maintain higher interest rates in Norway than in most comparable countries.

A special feature of wage formation in Norway has been that conditions for exposed industries, including those that do not face international competition, have received considerable emphasis in the negotiations. The last few years, the sheltered sector has had a greater influence on overall wage developments.

The centralised income settlements in Norway have been an arena of coordination, where macroeconomic considerations have at times received considerable emphasis. This has contributed to low unemployment levels in our country. But we have also seen that the income settlements may be a source of economic disturbances. The income settlements in 1974/75 and 1986 have had the strongest negative impact. The settlements in 1998 and 2000 also fuelled higher cost inflation. In 1998, high wage growth, combined with the fall in the krone exchange rate, contributed to a 4 ½ percentage point rise in interest rates during the spring and summer months. The retail and service industry almost acted as a spearhead in this wage negotiation. During and after the wage settlement in 2000, short-term interest rates rose by 1½ percentage points.

We have also seen that income formation is affected by labour market conditions and profit trends in the business sector. This is also true of wage and income developments among managers, salaried employees and the liberal professions. The structural changes that now seem to have occurred in the income formation for these groups has probably also been important for the outcome of the ordinary wage settlements.

Distributive trades

Growth in wages and labour costs in distributive trades has also been high the last five years, with an average wage growth per normal person-year of 5 per cent, the same as for mainland Norway.

National accounts figures for service industries are more uncertain than figures for manufacturing industry. Measuring productivity in service industries is difficult. The chart shows that according to the national accounts, productivity growth is very volatile.

If we smooth the data somewhat, it appears, however, that productivity growth has been relatively high through the 1990s, following low growth at the end of the 1980s. At the very end of the 1990s, however, productivity growth was weak.

One source that may be used to analyse developments in distributive trades is Norges Bank's database Sebra which contains figures for all limited companies that have turned in valid accounts to the Brønnøysund Register. The figures, from 1988 to 1999, show that profitability in this industry has been positive since 1993. Both measures of profitability show a slightly falling trend from the peak year 1994 to 1998. In 1999, it appears that profitability improved again. The increase in profitability from the end of the 1980s to the mid-1990s reflects a structural development in the industry since the 1980s. The most important changes were the emergence of chains and the development of shopping centres. When the upturn came in the mid-1990s, a better structure was in place. Both the chains and the shopping centres have increased their market shares.

This structural development has probably made it possible to maintain satisfactory profitability at the same time that profit margins[2] have declined. Operations became more efficient. Profitability has been satisfactory despite lower mark-ups on the cost of goods. In 1998 and 1999, however, profit margins increased somewhat.

The higher profit margins since 1997 may reflect the greater concentration in the grocery trade.

Labour cost growth and wage costs as a share of income in distributive trades declined sharply until the mid-1990s and have since picked up. This had the opposite effect on operating margins[3] , which fell in the five years to 1999.

One possible explanation is that weaker competition in distributive trades the last few years has made it possible to increase profit margins without losing market shares and thereby weakening profitability. This may also have contributed to the industry's role of spearhead in the wage settlement in 1998.

However, a fresh report from the Norwegian Agricultural Economics Research Institute and ECON shows that gross margins[4] on meat in the grocery trade were reduced somewhat between the spring of 1999 and the autumn of 2000. Farmers' margins fell fairly markedly. The survey concludes that it is primarily the processing industry that increased margins on meat products in this period.

A substantial share of the food industry is sheltered from international competition through trade policy measures. Analyses conducted by Statistics Norway show that productivity growth in this industry was very low between 1993 and 1999.[5] Weak productivity growth in this industry and in the graphics and publishing industry contributed to the substantially poorer productivity growth in Norway compared with Sweden in this period. A substantial share of the graphics and publishing industry is characterised by natural protection against foreign competition.

Excluding border trade, distributive trades are exposed to foreign competition only to a limited extent. Exposure to international competition is a source of learning, innovation and development for industries. It is essential, in my view, to maintain a broad internationally exposed sector in the mainland economy. At the same time, constructive unrest in retail and service industries and other sheltered industries, with new entrants, mergers and demergers, could also promote efficiency and lower prices.

Conclusion

The operational mandate for monetary policy is to stabilise inflation around 2½ per cent. Prices for goods and services that are set by commercial and service enterprises are an important component of the consumer price index. It has therefore been a pleasure for me to provide this assembly with a presentation of how Norwegian monetary policy is conducted.

Thank you for your attention.

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