Current Economic and Monetary Policy Issues

Address by governor Kjell Storvik. The 43rd annual general meeting of FOREX NORWA, 28 August 1998.

You will readily appreciate the limited pleasure I take in availing myself of this opportunity to provide an account of developments in money and foreign exchange markets. The annual general meeting of FOREX is, however, an extremely important forum and is taking place at a crucial time for developments in money and foreign exchange markets. Therefore, I attach particular importance to the opportunity this evening to present Norges Bank's views concerning the current situation.

Furthermore, I would naturally like to emphasise the importance of nurturing the good relationship which exists between Norges Bank and the foreign exchange brokers in the Norwegian market.

You will shortly come together at your annual banquet following a turbulent and arduous week. Far be it from me to spoil this occasion, although I will take the opportunity you have given me to present some of the main features of the economic situation and the challenges this poses to the implementation of monetary policy, from Norges Bank's viewpoint.

At the international level, an eventful year lies behind us. The Asian crisis has had dramatic consequences for the currencies of many countries, including the world's three major currencies. The problems in Russia over the last few days have intensified the uncertainty attached to international economic developments. Next year will see the introduction of a new major European currency, the euro. The Norwegian krone has not remained untouched by all these events. During the summer, and the past few weeks in particular, the Norwegian krone has been exposed to considerable pressure, and Norges Bank has raised its key interest rates a number of times.

Before embarking on a discussion of monetary policy, I would like to comment on the economic situation in Norway today.

The economic situation

In order to fully understand the present economic situation in Norway, it is necessary to take a longer term retrospective look at developments since the beginning of the 1990s.

The Norwegian economy is now experiencing its sixth consecutive year of strong growth. Since 1992, this growth has been broad-based, with a sharp expansion in traditional exports, deliveries of capital goods and services to the offshore sector, in the sheltered industry and private and public consumption. The traditional fishing and fish-farming industries have also recorded substantial growth in the 1990s, and in periods Norway's traditional shipping industry has also experienced solid growth. The chart, accompanied by some figures, will help to illustrate developments in mainland Norway.

Total demand for goods and services produced by mainland industries is around 30 per cent higher this year than in 1992.

From 1992 to 1998, annual mainland output has increased at constant prices by some 23 per cent, and demand for traditional imports has increased by more than 60 per cent.

During the same period, production growth combined with considerable revenues from oil and gas activities has increased Norway's disposable income by almost 50 per cent.

Substantial petroleum revenues have contributed to large central government budget surpluses in the 1990s. This has enabled the government to accumulate capital in the Petroleum Fund and the entire capital in the Fund is invested abroad. At the end of the second quarter of this year, the Petroleum Fund had a balance of nearly NOK 136 billion - almost 12 per cent of GDP.

Let me, in passing, add the following more positive judgement on economic policy in contrast to the strong criticism directed towards the politicians these days. The decision to establish the Petroleum Fund as an instrument in a long-term stability strategy, the decision to transfer the government budget surplus on a regular annual basis to the Fund and, finally, the decision to invest all the capital in the Petroleum Fund abroad deserve considerable respect. These decisions have been made in spite of strong pressures to increase government budget expenditure and also to invest part of the Fund's capital in Norwegian markets. The resistance to these strong pressures makes me optimistic about the fiscal policy framework for 1999 and onwards.

At the same time, current account surpluses in the 1990s have averaged 4 per cent of GDP. These large surpluses have made Norway a net creditor nation today. Norway's net foreign financial assets amounted to 7 per cent of GDP at end-1997.

The growth in the economy has created over 200 000 jobs since 1992, and Norwegian unemployment has now dropped to 3 per cent of the labour force. This is one of the lowest unemployment rates in Europe. At the same time, price inflation has remained low to date.

There were a lot of figures in that account, but they have something in common: they are all positive figures. Norway's favourable economic performance in recent years must be viewed against the backdrop of the economic downturn of the late 1980s and early 1990s, and the economic policy conducted thereafter. The downturn at that time led to a persistent decline in employment, and a record high 6 per cent unemployment in the early 1990s. The expansionary fiscal policy stance maintained over several years was not sufficient by itself to reverse this trend. The mandate of the Employment Commission, appointed in 1991, was to "... assess various potential strategies for achieving higher employment on a durable basis." The Commission presented its recommendations in 1992 as the "Solidarity Alternative". Partly thanks to the fall in interest rates through 1993, the Solidarity Alternative has yielded positive results for the Norwegian economy.

The main objectives of Norway's economic policy are to ensure full employment and to secure a durable basis for sustainable economic growth. Norway's economic policy is based on a strategy established between the authorities and the social partners in the early 1990s, whereby responsibility for economic policy is divided into three areas:

Fiscal policy, first and foremost the central government budget, forms the cornerstone of stabilisation policy. Fiscal policy is to be used to smooth cyclical fluctuations, and fiscal policy shall be oriented to ensure long-term economic stability.

The role of monetary policy is to orient instruments with a view to maintaining a stable exchange rate against European currencies. As such, monetary policy is not a stabilisation policy instrument.

The task of the social partners is to lay the necessary foundation for employment through moderate pay increases which ensure reasonable income growth while helping to maintain the competitiveness of the business sector.

In other words, the different components of economic policy are closely interlinked. In order to achieve stable and balanced economic growth, the various elements of economic policy must be oriented towards attaining the same objectives. If one of the elements of economic policy does not function as intended, the other components will not necessarily be able to sustain the extra burden this imposes.

In 1996, however, there were already signs of growing pressures in the economy. The concern over trends in the Norwegian economy expressed by Norges Bank at that time was motivated by the ability - or rather inability - we have shown when trying to stabilise economic developments over the past ten to fifteen years. In recent inflation reports, Norges Bank has stressed that the strong growth in the Norwegian economy will, sooner or later, be followed by more normal growth rates or, at worst, stagnation. Our models indicate that such a turnaround could occur around the turn of the century.

I will in this connection point to the summary presented in Norges Bank's *Inflation Report* from December 1996, almost two years ago. With regard to the outlook for the labour market and wage and price inflation, the report states:

"....The projections show ...a gradual decline in unemployment to close to 3 per cent in the year 2000. The projections also show a gradual rise in price and wage inflation, with price inflation estimated at an annual 3 per cent and wage growth at 5 1/2 per cent at the end of the projection period.

If these projections prove accurate, hourly wage costs in the business sector will rise by about 6 per cent more than among our trading partners during the last half of the 1990s."

The chart shows an indicator for the tightness of fiscal policy. A positive value indicates that fiscal policy is having a contractionary effect. As we see, the economic growth which we have experienced in Norway has been deliberately stimulated since the end of the 1980s. As growth gradually slowed, fiscal policy was, at first, shifted away from an expansionary stance towards an orientation aimed at moderating growth. As the chart shows, 1994 was the first year in this decade when fiscal policy was tightened, but the tightening effect has become weaker in recent years. This year, when the pressures in the economy are starting to reach a threateningly high level,fiscal policy is not having a noticeable contractionary effect, but rather a neutral effect. At the same time, interest rates have been very low until recently, which has also helped to stimulate economic activity. In other words, fiscal and monetary policy have made little contribution to stabilising the Norwegian economy in recent years.

The labour market is perhaps the market which best reflects the pressures in the Norwegian economy at present. The growing shortage of skilled labour in a number of sectors and geographical areas have translated into a wage growth which is likely to reach about 6 per cent this year, and we project a further rise in wage growth next year. Wage growth in Norway is now appreciably higher than that of our trading partners, and will weaken competitiveness in the exposed sector. This wage growth is not attributable to any particular greediness on the part of the social partners, but rather to the shortage of labour as a resource. Employment is now growing by 60 000 on an annual basis. In recent months, the number of vacancies has stood at a little more than 20 000, which represents more than a twofold increase over the last two years. Whereas there were 20 unemployed to each vacancy in 1993, this figure has now fallen to two. In our view, the acceleration in wage growth can primarily be ascribed to the economic policy conducted over the last few years, which is now generating pressures in the labour market.

The division of responsibility for economic policy seems to have yielded favourable results in the form of high growth, rising employment and low price inflation over several years. Nevertheless, in the course of the last year and a half we have seen increasing evidence of strains on the system as a result of the sharp cyclical upturn in Norway. This partly reflects the orientation of overall economic policy and particularly the absence of a necessary stabilisation effect through fiscal policy. There are limits to what extent economic policy can have a full effect when demand growth is driving the economy towards or even beyond capacity limits. At some point market forces are bound to take over in response to growing imbalances. The wage settlement this year was hardly in keeping with the intentions of the Solidarity Alternative, but was primarily the result of pressures in the economy which have led to a tight labour market.

In this context it is important to note that the Norwegian economy is highly vulnerable to cyclical fluctuations. The petroleum sector is of substantial importance to our economy, and mainland industries are largely commodity-based. This means that the Norwegian economy, like other small and open economies, is vulnerable to fluctuations in the international economy. Whatever the choice of exchange rate or monetary policy regime may be, there will be considerable challenges associated with stabilising an economy which is that heavily exposed to cyclical fluctuations.

Last autumn, Norges Bank's Executive Board conducted a review of the economic situation, including exchange rate management, and recommended that the political authorities revise the Exchange Rate Regulation in order to provide greater flexibility in exchange rate management.

The Government considered this question and, with the approval of the Storting, concluded that the Exchange Rate Regulation would continue to apply and that no changes would be made to the exchange rate regime. Norges Bank has taken note of this and complies fully with the political decisions.

Even if the Government should decide to change the regime at a later stage, it seems to me that, whatever the circumstances, fiscal policy must continue to bear the main responsibility for stabilising the economy and that monetary policy in this context must play a considerably more modest role.

It is Norges Bank's view that it is still not too late to tighten fiscal policy, and that this is necessary. If fiscal policy cannot contribute by delivering a budget which provides a controlled tightening, the tightening may come through market reactions and changes in household and business expectations. We will have much less control over a tightening which comes about through these channels and the adverse effects may be far greater. We are now in a situation where economic policy, in my opinion, must be geared towards limiting the damage which has already been done. A moderation in growth rates has been considered necessary for some time, partly in view of the surge in activity levels experienced in recent years. I have noted that the Government intends to present a tight budget programme for 1999. I would underline that this would facilitate the implementation of monetary and exchange rate policy.

Monetary policy

The krone exchange rate has moved on a weaker trend since the autumn of 1997, in spite of a current account and government budget surplus. Some of the depreciation can be attributed to conditions beyond our control, taking into account our relatively open economy. The escalating crisis in Asia, particularly in Japan, has contributed to sharp movements in international capital markets and a reduction in international growth. This has had an adverse effect on the krone exchange rate in addition to the currencies of other commodity-based countries, such as Canada and Australia. It seems that the fall in oil prices which, among other things reflects lower demand in Asia and a mild winter, is one of the main explanatory factors behind the weakening of the krone. But we have seen that political uncertainty and the fear of overheating in the Norwegian economy with the attendant risk of an inflationary spiral, have also contributed to the depreciation of the krone.

The recent depreciation of the krone has continued in spite of repeated increases in key rates. The question has been raised as to whether the mounting pressure on the krone in the very last weeks is more speculative in nature than a response to economic fundamentals. It must be assumed that some participants have taken speculative positions, but one must bear in mind that it is not always easy to distinguish between speculation and an attempt to protect one's own financial interests.

In order to counter the steady weakening of the krone exchange rate, Norges Bank has raised key rates in seven steps this year, by a total of 4 1/2 percentage points. The use of instruments is based on a thorough assessment of developments in money and foreign exchange markets. I have emphasised on several occasions - in connection with the press conferences we have held when raising interest rates - that the use of instruments is solely determined by exchange rate management considerations. On each occasion we have exercised our best professional judgement within the framework of the Exchange Rate Regulation, while faithfully executing the task assigned to us by the political authorities.

Norges Bank's use of monetary policy instruments has also - particularly in the last few days - been the object of speculation on the part of various commentators and the media. Some comments border on what I would call a conspiracy theory, insinuating that Norges Bank is in fact pursuing another objective than exchange rate stability, and that this is the motive behind the central bank's actions. It has also been insinuated that Norges Bank, through its interest rate increases, is seeking to influence the stance of politicians with a view to promoting the viewpoints presented by the central bank in its advisory role.

Norges Bank's use of instruments has consistently been based on the guidelines applying as laid down in the Exchange Rate Regulation of 6 May 1994. This states (and I quote): *"The monetary policy to be conducted by Norges Bank shall be aimed at maintaining a stable krone exchange rate against European currencies, based on the range of the exchange rate maintained since the krone was floated on 10 December 1992. In the event of significant changes in the exchange rate monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range. No fluctuation margins are established, nor is there an appurtenant obligation on Norges Bank to intervene in the foreign exchange market."*

It is also clear from the monetary policy guidelines issued in the subsequent comments to the budget that Norges Bank's instruments shall not be used to stabilise the krone to the same extent as under a fixed exchange rate regime without this being further specified.

The guidelines contain three important elements. First, Norges Bank's operational role is to orient its instruments towards exchange rate stability. This means that Norges Bank's use of instruments is based on the exchange rate level. Second, and as mentioned, it is stipulated in the comments to the central government budget that the use of instruments shall not be used to the same extent as under a fixed exchange rate regime. This means that Norges Bank will not intervene in the market to an unlimited extent, and that there are limits to how high or low interest rates can be set. Third, I would like to stress that neither now, nor in the period prior to 24 August 1998, has any specific krone exchange rate been established which would automatically trigger central bank interventions or a change in the interest rate.

In line with this, Norges Bank has not intervened heavily over the last one and half years to stabilise the krone exchange rate. Developments in January 1997 demonstrated that Norges Bank's foreign currency purchases had a self-reinforcing effect. Our assessment of the present situation was that a similar effect might easily occur this time. Internationally and in professional circles, it is widely perceived that interventions as a rule have limited effects.

The use of the interest rate in exchange rate management is considered, under the Norges Bank Act, to constitute a matter of special importance which is to be submitted to the Ministry of Finance before any decision is taken by the central bank. The Ministry has not made any comments on the decisions to change interest rates.

It goes without saying that decisions concerning the use of instruments are seldom easy to make. We never know with full certainty the interest rate changes which are necessary or sufficient to stabilise the exchange rate. However, our professional judgement has been exercised while remaining fully loyal to the task assigned to us by the political authorities.

Therefore, I would like to emphasise that the interest rate changes that have been implemented fall well within the Exchange Rate Regulation. I would point to the well-known fact that a lower krone exchange rate may contribute to fuelling inflation expectations and that such expectations may in turn generate expectations of a weakening of the krone exchange rate, thereby reinforcing depreciation pressures. Price expectations may thus prove to be a self-fulfilling prophecy. The interest rate level which has now been established should, in addition to directly contributing to stabilising the krone exchange rate, dampen price expectations, which in turn implies that expectations of a further depreciation will gradually recede.

In this context I would like to point out that an important consideration underlying the choice of exchange rate stability against European currencies as the objective of monetary policy was to stabilise the krone against low-inflation countries. The exchange rate anchor would thereby contribute to low inflation.

In response to Norges Bank's most recent decision to change interest rates on Monday of this week, money market rates declined by a substantial margin. The exchange rate has weakened somewhat since then. I maintain that instruments are oriented with a view to returning the krone back to the range observed since the krone was left to float in 1992.

I also note that the Government intends to present a tight budget for 1999 and that the social partners increasingly recognise the importance of avoiding a recurrence of this year's wage settlement.

My perception is that Norges Bank's strategy based on the existing guidelines has contributed to stabilising money market rates and will gradually also contribute to returning the krone exchange rate to the range observed since the krone was left to float in 1992. The interest rate level which has now been established will, in our assessment, not have any serious adverse effects on the Norwegian economy. Monetary policy must therefore be viewed as having a credible orientation in relation to the regime which has been drawn up by the political authorities.

Conclusion

At times, the heated debate in Norway over the past few days seems to give the impression that the cause of all the problems now affecting the Norwegian economy lies in the Exchange Rate Regulation.

Let us acknowledge that we are facing international events and developments that are beyond our control, but which are of considerable importance to the Norwegian economy. The Asian crisis, which is now having a greater impact on the rest of the world than we had anticipated, and the serious problems in the Russian economy have to a large extent contributed to this situation. Lower international economic growth, particularly in Asia, is resulting in a drop in oil prices, lower prices for our commodity-based industries, and a reduced demand for international transport, which in turn affects rates and services in Norway's shipping companies. Our outward-oriented economy, in which foreign trade accounts for about half of our Gross Domestic Product, is particularly vulnerable to international developments of this nature. We need to look no further than to Canada and Australia for a parallel.

I have mentioned Norges Bank's clear warnings going back to 1996 on the need to conduct a tight economic policy in order to prevent an overheating and a negative trend in prices and costs.

I have also pointed to the need for the political authorities to take policy formulation seriously and to adhere to its own premise - which means that it is fiscal policy that is to contribute to stabilising the economy, and that it is through fiscal policy that the steps necessary to ensure stability must be taken.

We may feel confident that the political authorities - in the light of the serious economic situation - will now formulate a fiscal policy which is appropriate and adequate in the current situation, and I am convinced that an adequate fiscal policy programme will contribute to facilitating the implementation of monetary policy.

Allow me to conclude with a few additional observations:

The Norwegian economy is exposed to strong cyclical forces as a result of the oil sector's major importance to the economy as a whole and the substantial scale of commodity-based industries. This poses considerable challenges to Norway as a nation both in terms of the formulation and implementation of economic policy. The importance of recognising the need for a significant, stabilising element in economic policy has perhaps not been the primary focus in Norway. When fiscal policy is designated as the cornerstone of stabilisation policy, the political system in Norway is persistently confronted with the challenge of striking a balance between long-term fiscal policy considerations and the achievement of high-priority policy objectives.

The absence of sufficient focus on stabilising the Norwegian economy has engendered a situation characterised by a growing risk of a hard landing with high inflation and rising unemployment. The uncertain economic situation, in conjunction with a decline in international demand, has had a negative impact on the Norwegian krone since last autumn. The krone exchange rate seems to have been particularly vulnerable to the negative trend in oil prices observed since the beginning of the year.

However, the positive news is that there are now signals that other policy components will clearly focus on stabilising the economy.

The question of revising the exchange rate regime has been considered by the Government and the Storting. Norges Bank has duly noted that exchange rate stability is the operational objective of monetary policy, and has based its use of monetary policy instruments on this fact. In the light of the krone's depreciation, Norges Bank has loyally oriented and implemented its use of instruments pursuant to the monetary policy regime laid down by the political authorities. The orientation of monetary policy instruments is based on the central bank's best professional assessment in the light of the turbulence we have recently experienced.

This orientation of instruments is, in our view, clearly geared towards gradually returning the exchange rate back to the stipulated range. Therefore, we deem that it is unnecessary to make further changes, as we clearly indicated on Monday this week.