

Interest rates, inflation and the exchange rate

by Jarle Berge, Deputy Governor of Norges Bank, Dagsavisen 24 August 2003.

Norges Bank reduced its key rate to 3 per cent at its meeting on 13 August. Since December last year, the key rate has been reduced by a total of 4 percentage points, and the krone has depreciated by around 10 per cent. Interest rates are set based on the mandate issued by the Government to Norges Bank, which defines an inflation target for monetary policy. The inflation target is set at 2½ per cent.

Global economic growth has been weak, particularly in western Europe. Price and cost inflation is low among our trading partners, and is expected to remain subdued. Key policy rates have been reduced in all western countries. In the US, the key rate is record low at 1 per cent, and the ECB's key rate is at 2 per cent. Even though signs of renewed optimism have emerged, particularly in the US, economic developments have been considerably weaker over the past year than Norges Bank and other observers, both analysts and international organisations, had projected.

In Norway, capacity utilisation has fallen from a very high level, and is now on a par with the level in the years 1995-1997, before cost inflation accelerated. However, growth in the domestic economy came to a halt this winter.

At the same time, the underlying rise in prices has slowed markedly. In July, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) was 0.7 per cent, which is markedly lower than the inflation target.

There are also prospects that inflation will remain subdued ahead. Without a considerable easing of monetary policy, inflation might be too low for an extensive period. This may in turn fuel expectations of continued very low inflation. This is a situation that we must seek to avoid, also because it could prove more demanding to stimulate economic activity by means of demand management. Monetary policy must therefore react.

Lower interest rates will normally lead to higher inflation, partly through a depreciation of the krone and partly through rising demand in the economy, with an associated increase in corporate earnings.

For the Norwegian economy, it would be a considerable advantage if wage growth does not accelerate again. Many years of sharply rising labour costs and deteriorating competitiveness in the Norwegian enterprise sector mean that the room for wage growth is very limited. Over time, wage growth of around 4½ per cent, combined with trend growth in productivity of 2 per cent, would be consistent with an inflation rate of 2½ per cent. Profitability in many industries is low. In the local government sector, the increase in revenues has been negated by the high wage increases in recent years, with adverse effects on service production.

The spring wage settlement and information on local wage developments so far this year would indicate a more moderate wage settlement ahead than in the years between 1998 and 2002, even with the interest rate reductions. The outlook for a more sustainable level of wage growth has been an important factor behind the considerable easing of monetary policy.

The depreciation of the krone plays an important role in bringing inflation back towards the target of 2½ per cent. The fall in prices for imported goods reflected to a large extent the strong krone last year. As the effects of this unwind, inflation will pick up again. In addition, the krone has depreciated markedly so far this year. This will normally push up inflation towards the stipulated target.

Recent years' wage settlements have strengthened households' financial position at the expense of private and public enterprises. Against this background, growth in private consumption is likely to be fairly robust. At the same time, the business sector is still feeling the effects of the sharp rise in labour costs between 1998 and 2002, and corporate credit demand and investment are low. The most effective stimulus to business activity is the combination of low interest rates and a weak krone. A precondition for this is moderate wage growth.