Monetary policy in an oil economy

by Svein Gjedrem, Governor, Norges Bank, Dagsavisen, 28 August 2002.

The global economy is characterised by financial market turbulence, low growth and rising unemployment. Even though the global unrest has had an impact on some sectors of Norwegian business and industry, activity in the Norwegian economy as a whole is still high, with solid growth in demand for goods and services. Aggregate demand is being fuelled by strong growth in household income. There is also a high level of activity in the petroleum sector and oil prices are high. Petroleum investment remains buoyant. The labour market is tight. This is reflected in the relatively high wage increases in Norway. Growth in labour costs has been considerably higher in Norway than among our trading partners for several years. Combined with the global downturn and a strong krone, this is having a severe impact on manufacturing.

Scaling back manufacturing involves a risk. It makes the economy more vulnerable. The growth potential of the economy - the basis for learning, innovation and development - may be impaired when less of the business sector is exposed to intense foreign competition.

High wage growth affects the exposed business sector in two ways. First, it erodes earnings and reduces employment. Second, monetary policy has to be tightened. This leads to an appreciation of the krone, with a further reduction in earnings and employment.

During the 1990s, we saw that unemployment declined as long as wage growth in Norway was lower than wage growth among trading partners. This came to a halt in 1998, when the social partners rejected a policy of wage moderation. Unemployment stopped falling.

Growth in labour costs jumped in 1998, and has since been around 2 percentage points higher than among our trading partners, ranging between 5 and 6 per cent each year. This year's wage settlement appears to be following suit. The outlook suggests that cumulative wage growth in Norway will be a good 15 per cent higher than in other countries from 1998 to 2003. The krone is about 7 per cent stronger than the average for the 1990s. The appreciation of the krone is probably reversible, but the loss of competitiveness and jobs caused by the high level of domestic wage growth is difficult to redress.

The sharp rise in labour costs in recent years carries with it a potential for higher unemployment. The interest rate is an effective instrument for countering lower demand and growing unemployment when stronger demand does not translate into higher wage growth or unstable financial markets. However, there is little monetary policy can do to prevent an increase in unemployment that is driven by high labour costs.

The Norwegian krone has appreciated markedly this year. An important driving force has probably been developments in wage settlements. Operators in the foreign exchange market have reacted as could be expected. High wage growth eventually leads to high interest rates, which makes it attractive to take krone positions and borrow in foreign currency. As a result, the Norwegian krone strengthens.

In other words, the krone is strong because wage growth is high and demand is expanding. But the krone can move in both directions. It will not appreciate indefinitely. Over the last two years, the appreciation of the krone has been driven by the wide and increased interest rate differential between Norway and other countries. The interest rate differential reflects high wage growth in Norway. In other words, easily comprehensible forces have been behind the changes in the krone exchange rate. But most likely these forces are also reversible. If wage growth moderates and there is confidence that it will remain low in coming years, the interest rate differential against other countries can be narrowed. Normally this will lead to a depreciation of the krone.

The operational objective of monetary policy, as laid down by the Government, is low and stable inflation. The inflation target is set at 2½ per cent. The current interest rate has been set in accordance with this target. However, there is also a close relationship between the inflation target and stability in economic developments and in the krone exchange rate. A monetary stance resulting in high and varying inflation would have led to wider swings in production and employment. It would also have been a recipe for turbulence in the foreign exchange markets.

The interest rate influences inflation through two channels: through domestic demand for goods and services and the krone exchange rate. When interest rates rise, it is more profitable to save and more costly to borrow. This has a dampening impact on consumption and investment. Lower demand in turn curbs the rise in prices and wages. Higher interest rates also make it more attractive to take krone positions and borrow in foreign currency. As a result, higher interest rates normally lead to an appreciation of the krone. This reduces prices for imported goods. In addition, a strong krone curbs activity, profitability and the ability to pay in the internationally exposed sector, and thereby cost pressures in the Norwegian economy.

High interest rates and the strong krone reflect real economic driving forces such as a high level of petroleum revenues, a tight labour market and strong growth in household income, consumption and borrowing. A shift in the wage formation process may have added to the particularly high rate of overall wage growth. If these forces are restrained, there is also hope that the pressures on monetary policy will subside.