

# Interest rate developments

Speech by Governor Svein Gjedrem at the annual conference hosted by the Norwegian Federation of State Employees' Unions, on 28 November 2007

*The text below may differ slightly from the actual presentation. The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 31 October and in Monetary Policy Report 3/07.*

## Introduction

Good morning. First of all, I would like to thank you for inviting me to this conference. As the title suggests, my speech today will focus on the interest rate and monetary policy.

## What is monetary policy's role?

Over the past 100 years, there have been four periods of very high inflation in Norway: during the two World Wars, during the Korean War and in a 15-year period from the first half of the 1970s to the second half of the 1980s. The last of these three periods was different from the preceding periods. In the 1970s and 1980s, inflation accelerated gradually. Inflation did not reach the same level as it did during the two world wars, but it took longer to fall.

Substantial economic losses and financial instability followed in the wake of high inflation. Inflation was very costly.

History shows that there is no long-term trade-off between lower unemployment or stronger economic growth and higher inflation. If we look at the period from the 1970s to today, economic growth has been higher since the 1990s when inflation was low than it was in the 1970s and 1980s when inflation was high.

Over time, interest rate setting only has an impact on inflation. Output is determined by real factors such as the supply of labour, capital and technology and by productivity developments.

Nevertheless, monetary policy can have an impact on the real economy in the short and medium term. Actual output will normally deviate from trend output, which is determined by developments in real factors. If output is higher than implied by these factors, price and cost inflation will pick up. Stabilising output developments means seeking to influence actual output so that the economy grows at a pace that is consistent with price and cost stability.

In line with this, the operational target of monetary policy is low and stable inflation, with annual consumer price inflation of approximately 2.5 per cent over time. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment.

A plan for petroleum revenue spending over the central government budget was drawn up in 2001. Government revenues from the sale of oil and gas are invested in the Government Pension Fund – Global (the petroleum fund). The plan is to spend the expected real rate of return on the Fund each year, i.e. 4 per cent of the Fund's value as an annual average through the business cycle.

This establishes a clear division of labour among the different components of economic policy.

- Monetary policy steers inflation in the medium and long term and can also contribute to smoothing swings in output and employment. The inflation target provides economic agents with a stable basis for their decisions concerning saving, investment, budgets and wages.
- The central government budget – growth in public expenditure – influences the krone exchange rate and the size of the internationally exposed business sector in the medium term. Government expenditure and revenues must be in balance in the long term.
- How well and how efficiently we utilise our labour resources and other economic resources is largely determined by wage formation and economic structures and incentives.

When monetary policy anchors inflation expectations, this provides a sound basis for the interplay between monetary policy and other components of the economy.

Inflation targeting provides a fixed framework for monetary policy and gives a clear indication of how the central bank is to respond in different situations. The social partners can determine wage growth in the knowledge of the monetary policy response. This system works well whether wages are set at the central, local or individual level.

In the initial period after the introduction of an inflation target in 2001, it appeared that the social partners had not yet internalised the response pattern ensuing from the monetary policy mandate. We are now well into a cyclical phase with very high capacity utilisation and low unemployment. In this situation, there may be a risk that wage growth will again accelerate. On the other hand, the experience gained by the social partners that large pay rises push up interest rates may have the effect of curbing pay increases. In local wage negotiations at enterprise level, competition, the supply of foreign labour and the possibility of outsourcing or relocating activities abroad may dampen the impact.

The inflation target of 2.5 per cent provides a framework for the social partners. Over time, nominal wage growth above 2.5 per cent will mean higher real wages and higher purchasing power. Real wage growth that exceeds productivity growth can lead to higher inflation and higher interest rates.

In government-financed enterprises – often labour-intensive – budgets are adjusted to the wage growth expected by the Government. This is usually in line with assumptions about cost inflation in the economy as a whole and with the inflation target. If wages rise more sharply, efficiency must be increased in order to minimise the adverse impact on service production and customers.

Norges Bank's most important instrument is the interest rate on banks' deposits with Norges Bank (the sight deposit rate), also referred to as the key policy rate. The key policy rate

influences interest rates on interbank loans. Banks' deposit and lending rates and bond yields depend on the current key policy rate and expectations as to future changes in this rate. Lending rates in state banks are also linked to the interest rate on interbank loans and bond yields.

The aim of preventing inflation expectations from becoming entrenched below the operational target of 2.5 per cent was one of the main reasons the interest rate was lowered to a very low level in 2003 and 2004, when inflation receded and approached zero. Low interest rates have stimulated demand and output and gradually led to the prospect of higher inflation, which we are addressing by increasing the interest rate.

The labour market is an important factor in how the interest rate functions. A rise in the interest rate curbs aggregate demand for goods, services and labour, and eases the pressure on wages and prices. These effects are amplified by the impact of the interest rate on the krone exchange rate. Higher interest rates contribute in isolation to krone appreciation and to lower profitability in the internationally exposed sector. This can result in lower employment and wage growth in this sector. Expectations with regard to price developments also influence wage demands and have an effect when companies adjust their prices. The inflation target can provide an anchor for these expectations.

Even though demand for labour is strong, there is a risk that outflows from the labour market to various social security schemes will remain high. Sickness absence is high, and the share of the working-age population on rehabilitation schemes or receiving disability pensions is rising. Many wage-earners choose to take early retirement under the AFP scheme (contractual early retirement) when they reach 62 years of age, and – because this age group is expanding sharply – this number will probably increase in the next few years. In Norway, close to 600 000 persons of working age receive social security benefits or pensions. This is equivalent to 25 per cent of the labour force. This is the Norwegian economy's Achilles' heel. A particularly disturbing aspect is that disability is increasing among young people. [\(1\)](#)

In economic terms, Norway's substantial petroleum wealth gives it a unique position compared with many other countries. Nonetheless, labour is still by far the most important resource we have. A well functioning labour market is therefore important for our welfare. Although it is difficult to quantify labour's contribution in exact terms, even a small increase in the "return" on labour could generate considerable gains.

Inflation in Norway decelerated markedly from the end of the 1980s to the mid-1990s and has since been low and stable, and fairly close to 2.5 per cent, with considerably lower variability than earlier. Over the past 5-10 years, inflation has averaged around 2 per cent, i.e. somewhat lower than the inflation target.

## **The current economic situation**

The Norwegian economy is in a period of strong expansion after a marked upturn began in summer 2003. The upturn followed a period of slow growth from 1998 and a mild recession

in 2002 and into 2003. So far in the cyclical upturn, the mainland economy has grown by an average of just over 4 per cent annually. This year, growth appears to be over 5 per cent.

Growth is very strong for such an advanced stage of the economic cycle. This is clear from a comparison with the upturns in the 1980s and 1990s.

There has been a sharp increase in the utilisation of production resources since 2003. The level of capacity utilisation is particularly high in the building and construction industry. Order backlogs in this industry and in some manufacturing sectors are full, and many companies say they cannot take on any new assignments. There are shortages of many inputs, not just labour. Contacts in our regional network frequently report purely physical production constraints. There is a shortage of rigs and equipment in the petroleum sector, and periodic shortages of planks, concrete, insulation and scaffolding in the building and construction industry. High capacity utilisation is placing limits on growth.

Pressures in the building industry are reflected in building costs, particularly the cost of materials, which has risen sharply. Building a detached home (in wood) today results in ten per cent less house per krone than it did just one year ago. But costs are increasing for all types of building and construction. Each million allocated over central and local government budgets now buys considerably fewer square metres of building and fewer metres of road.

Strong economic growth has so far only to a limited extent fed through to a higher rise in prices for consumer goods and services. Lower electricity prices have contributed to a fall in total CPI inflation in 2007. Consumer prices adjusted for tax changes and excluding energy products were stable at between 1 and 1½ per cent for a long period. Underlying inflation has edged up gradually since late summer 2006, and the most recent figures indicate that it now stands at approximately 1½ per cent.

Developments in recent years have paved the way for strong growth in employment, even now that the cyclical upturn is in a mature phase. The labour market is tight. Unemployment has not been as low since the latter half of the 1980s, and employment has risen faster this year than in living memory. It is estimated that the number employed will increase by 3.5 per cent this year, which would be the strongest rise recorded in the post-war period. The number of vacancies per unemployed has never been higher. There is a shortage of qualified labour in many industries.

Although unemployment is now very low, employees' share of value added has been reduced. This conflicts with previous experience. Historically, unemployment has been high when the wage share was low.

What are the factors that can explain the current situation of both low unemployment and a low wage share?

Developments have been influenced by a number of positive supply-side conditions.

First, due to high export prices and low import prices, we can now import considerably more for a given quantity of export goods. This means that Norway's terms of trade have improved considerably.

Second, an ample supply of foreign labour has been an important factor behind output growth. There was a particularly sharp increase in the supply of foreign labour after EU enlargement in 2004, and inward labour migration and population growth have risen to record-high levels. At the same time, this has enabled Norwegian companies to be bolder in accepting new assignments and making investments, in the knowledge that they can procure labour not only from the Nordic countries, but throughout Europe. Norwegian firms also have greater scope for relocating production to other countries if labour costs become too high. This has resulted in intensified competition in the labour market and has probably had a dampening effect on wage demands.

Third, productivity growth has been unusually strong, for both companies competing on international markets and those supplying goods and services to the domestic market. In comparison with other countries, this is particularly the case for banks and other service sectors, reducing their production costs. The business sector has been quick to adapt and change, and to make use of new technology that is available in an international market. This is probably due to the 1980s and 1990s' modernisation of the way the economy functions, which resulted in more efficient markets. In addition, growth in labour productivity reflected a marked fall in sickness absence in 2004. The latest figures nonetheless indicate that productivity growth is falling back.

Although we do not have satisfactory current statistics for central government and local government productivity, government agencies have probably also become more efficient. New technology and new organisational structures have certainly provided opportunities to increase efficiency.

Wage-earners and enterprises have both fared well. Low import prices have resulted in a slow rise in consumer prices and a solid increase in wage-earners' real wages. High export prices have contributed to holding down the rise in real wages. Combined with high productivity growth, this has resulted in high corporate earnings and solid growth in employment.

It remains to be seen whether the combination of low unemployment and a low wage share is sustainable. This partly depends on whether positive supply-side conditions persist. There is probably symmetry here.

First, should Norway's terms of trade deteriorate, productivity growth slacken and foreign workers return to their home country, the wage share will increase, profits fall and unemployment will rise. Second, if enterprises, in their search for the best qualified candidates, go so far as to bid up wages, profits may fall and unemployment edge up. Developments ahead will also depend on how wage-earners react. If the wage share has fallen solely because of a lag in wage formation, both wage shares and unemployment may increase.

High income growth and a sharp rise in the number of households laid the basis for a sharp, long-term rise in house prices. It now appears that the housing market is cooling after an almost three-fold rise in prices in real terms in the course of the past 14 years. In some regions, house prices are now approximately unchanged or lower than they were a year ago.

House price inflation has been accompanied by strong growth in household debt. Household debt in Norway is now about twice the level of disposable income, making the debt-income ratio higher than ever before. At the same time, saving is declining. This means that in addition to fully financing their housing investments through mortgages, households are also raising loans to finance current consumption.

Higher interest rates and falling house prices may lead to slower consumption growth and a gradual increase in saving.

## **Growth outlook and the orientation of fiscal and monetary policy**

I would like to conclude by commenting on the outlook for growth.

Global economic developments are important for economic developments in Norway, and changes in the growth prospects for the world economy may influence our forecasts.

Growth in the US economy has slackened. The US housing market has weakened and employment is rising at a slower pace than earlier this year. There are also signs of somewhat slower growth in western Europe. Economic growth in emerging economies remains strong, particularly in China. Developments in these countries are of growing importance for the world economy and for our own economy. China, India and Russia have accounted for close to half of overall global growth over the past year.

In spite of weaker prospects for the US and western Europe, oil prices have increased since the October Monetary Policy Report and prices for other commodities remain high, partly owing to continued strong growth in demand from Asia.

Uncertainty surrounding developments in the world economy has heightened as a result of the turbulence in financial markets this autumn. The turbulence was triggered by problems in some segments of the US housing market. Many borrowers were granted mortgages they cannot service now that the interest rate has risen. There were losses, particularly on loans in the bond market and in complex loan products owned by separate companies that had relied on very short-term financing. These companies are linked to the large international banks, and the banks have had to transfer loans onto their own balance sheets. Combined with higher losses, this limits banks' capacity to extend new loans to the housing market and other sectors, and will thereby have a dampening impact on economic growth. To prevent interbank lending rates from rising too much, a number of central banks have increased their short-term lending to banks.

In addition, the Federal Reserve has lowered its key rate by 0.75 percentage point in recent months. A further cut in the key rate in the US is now expected, and the interest rate is also expected to fall in the UK. In the euro area, market participants expect a more stable key rate ahead. But developments are not the same everywhere. The central banks in Sweden, Switzerland, Canada, New Zealand and China have raised their key rates. In Sweden, which has a lower interest rate level than our main trading partners, further interest rate hikes are expected.

The interest rate differential between Norway and other countries can have an impact on the krone exchange rate. In the short term, however, the factors that influence the krone exchange rate vary. High oil prices and krone appreciation appear at times to be related, but there have also been periods when the krone has appreciated while oil prices declined. The krone appreciated when the interest rate differential against other countries was high in 2002, but as interest rates in Norway moved down to the level among our trading partners, the value of the krone fell back. In the past, we have observed that market turbulence has occurred in tandem with a weaker krone. This autumn the krone appreciated during the period of market turbulence, but has weakened somewhat in the past two weeks, reflecting shifting themes in foreign exchange markets. However, it appears the krone will be a good 3 per cent stronger on average in the second half of this year compared with the first half, and about 1.5 per cent stronger this year than last year. Exchange rate developments have a dampening impact on inflation.

Given our inflation-targeting regime, we will be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low.

High oil prices have resulted in substantial growth in the petroleum fund's capital, and there are prospects of further growth ahead.

The Government uses the central government budget to influence economic developments. Government petroleum revenues are transferred in full to the Government Pension Fund – Global and invested in securities abroad. However, as part of the budget resolution, the Storting decides on an annual transfer from the Fund to cover the deficit in the government budget when petroleum revenues and capital income earned by the Fund are excluded. This annual transfer – direct petroleum revenue spending – has been sharply reduced in recent years, but is expected to increase somewhat next year. Developments reflect a marked increase in the government's general tax revenues as a result of the current period of strong expansion. This in turn reflects the automatic contribution made by the central government budget to curbing cyclical fluctuations because more money accrues to the state in good times than in bad.

If the economy had not been in a period of strong expansion, and the economic situation had been more normal, a considerably larger transfer from the Pension Fund to the Treasury would have been necessary in order to balance the budget. This cyclically adjusted transfer is estimated at a good NOK 71 billion this year, and just under NOK 77 billion in 2008, and has increased gradually over time. It is this estimate that forms the basis of the plan drawn up by the Government and the Storting, referred to as the fiscal rule. The rule states that the government is to spend, as an annual average through the business cycle, the expected return on the petroleum fund, i.e. 4 per cent. Because of the high level of activity, the Government has proposed using somewhat less money from the petroleum fund than 4 per cent of the Fund's value at the beginning of the year.

The proposed tax programme for next year will have a fairly neutral impact on economic activity. Proposed direct and indirect tax rates will generate approximately the same government revenues as last year's tax rates had they been continued. As a whole, however, the central government budget will have the effect of stimulating activity. This is reflected in

fairly strong growth in the level of expenditure, which is stronger than the rate of growth in mainland GDP that can normally be expected.

In the November 2005 Inflation Report, Norges Bank published its own forecast for the interest rate for the first time. The forecast satisfies two main criteria: First, the interest rate is set with a view to stabilising inflation close to the target in the medium term. The horizon will depend on the shocks to which the economy is exposed and their effects on the path for inflation and the real economy ahead. Second, the interest rate path shall provide a reasonable balance between the path for inflation and the path for capacity utilisation. In the assessment, potential effects of property prices and the krone exchange rate on the prospects for output, employment and inflation are also taken into account.

Even if Norges Bank presents an interest rate forecast, this does not mean that the interest rate will follow this precise path. The wage settlements may be different from what we envisaged, and there may be changes in the global economy, exchange rates, and petroleum and commodity prices that have an impact on the economy and the inflation outlook. This may result in a different interest rate path.

In the press release following the Executive Board's monetary policy meeting on 31 October, it was stated that underlying inflation has picked up but is lower than the inflation target. Growth in the Norwegian economy remains strong and is stronger than projected earlier. Capacity utilisation is high. Wage growth is on the rise and there are prospects of higher inflation. At the same time, the krone had appreciated markedly and there are prospects that somewhat weaker growth in the world economy will contribute to curbing inflation and growth in output and employment in Norway. Reference was also made to the analyses in Monetary Policy Report 3/07, which indicate that the key policy rate should be raised further, but to a lesser extent than envisaged in June.

In addition, the Executive Board pointed out that the projections are uncertain. New information may reveal aspects of economic developments indicating that the Norwegian economy is moving on a different path than projected. On the one hand, high capacity utilisation and higher cost inflation may lead to higher-than-projected inflation. On the other hand, the risk of slower growth in the world economy has increased. If global economic developments are weaker or if the krone appreciates more than we have assumed, inflation may be lower than projected at present.

It was the view of the Executive Board that the key policy rate should be in the interval 4¾-5¾ per cent in the period to the publication of the next Report on 13 March 2008, unless the Norwegian economy is exposed to unexpectedly severe shocks.

Thank you for your attention.

## Footnotes

1) See Elisabeth Fevang and Knut Røed (2006): "Veien til uføretrygd i Norge (The route to disability pensions in Norway)", Report no. 10 2006, Ragnar Frisch Centre for Economic Research. Norwegian only