The conduct of monetary policy

Governor Svein Gjedrem. Introductory statement at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), 28 September 2004

Please note that the text below may differ slightly from the actual presentation. The statement is based, among other things, on the assessments in Norges Bank's Annual Report for 2003 and Inflation Report 2/2004.

I would like to take this opportunity to thank the Storting for again inviting Norges Bank to appear before this Committee to report and answer questions on monetary policy in connection with the Storting's deliberations on the Government's credit report.

Inflation-targeting countries

Price stability, in the sense of low and stable inflation, is the objective of monetary policy in a number of countries. Historical experience from Norway and other countries has shown that high inflation has resulted in unstable output and employment. In addition, a fall in the price level will often accompany a period of decline.

The first inflation target was introduced in New Zealand in 1990. Canada followed in 1991, the UK in 1992, and Sweden and Australia in 1993. In Norway, the government issued a regulation introducing an inflation target in 2001. Monetary policy in euro area countries and Switzerland is also aimed at price stability, even though this is not referred to as inflation targeting in these countries.

Inflation targeting has proved to be particularly appropriate in very open small and medium-sized economies. Commodity exports play a particularly important role in several of the countries that were the first to introduce inflation targeting.

Exchange rates fluctuate

Over the past 10-15 years, many countries have made the transition from a fixed exchange rate regime to inflation targeting. In open economies with free capital movements, the exchange rate will be influenced by economic developments.

The krone fluctuates. This is not surprising because other countries' currencies also fluctuate. The krone exchange rate does not stand out as particularly unstable compared with other countries' currencies.

The krone exchange rate is the price of our currency measured in a foreign currency. Developments in other countries are just as important for the krone as developments in the Norwegian economy. Capital flows freely and flows can change rapidly. This can spill over to exchange rates and interest rates as well as output and employment.

There is a cost involved for businesses in hedging against fluctuations in the krone. A krone that is stable - but too strong - also entails costs to the economy in the form of low activity. Similarly, a krone that is stable - but too weak - is a source of high inflation.

Flexible inflation targeting
The most important contribution monetary policy can make to sound economic developments in the long term is low and stable inflation. The inflation target provides an anchor for economic agents' expectations concerning future inflation. We have a very open economy with free capital movements. Stable inflation expectations also contribute to more stable exchange rate expectations.

Inflation targeting means setting the interest rate so as to achieve a numerical target for inflation. Norges Bank sets the interest rate with a view to stabilising inflation at 2.5 per cent within a reasonable time horizon, normally 1-3 years. The more precise horizon will depend on the disturbances to which the economy is exposed, and how they affect the path for inflation and output.

The inflation target represents a framework for, not an obstacle to, monetary policy's contribution to stabilising output and employment. We have chosen flexible inflation targeting. Variability in output and employment as well as inflation is given weight.

The objective of monetary policy is to safeguard the value of money in the long term, and seek to contribute to stabilising economic developments in the short and medium term.

Like other central banks, Norges Bank publishes reports about the economic situation, the inflation outlook and the conduct of monetary policy. The transparency of the basis for monetary policy decisions has increased. Norges Bank presents an account of both the main aspects of economic developments that influence interest rate decisions and of the Executive Board's assessments. The alternatives considered by the Executive Board are made public. Interest rate decisions are taken on the basis of an interest-rate setting strategy drawn up by the Executive Board every four months. The strategy is now published as soon as it is adopted and prior to the relevant strategy period.

The interest rate affects the economy with a lag
The objective of monetary policy is low and stable inflation. The instrument is the interest rate. The interest rate influences inflation with a lag and with varying intensity.

As interest rates fall, household and local government consumption and investment will tend to accelerate. Higher demand leads to higher output and employment. Wage growth may pick up. Higher wage growth combined with higher profit margins will result in higher inflation.

Lower interest rates will normally lead to a depreciation of the krone. Imported goods will then become more expensive and inflation will accelerate.

Expectations play a key role in price and wage formation, and they are influenced by the interest rate. Expectations concerning future inflation and economic stability have considerable impact, not least in the foreign exchange market.

More stable inflation
Current inflation is low, but our recent history shows that without a nominal anchor inflation becomes high and variable with substantial effects on output and employment. In the 1970s

and 1980s, average annual inflation in Norway was over 8 per cent. The fixed exchange rate regime, which was introduced in 1986, reinstated monetary policy as an instrument of economic policy in Norway and laid the foundation for lower inflation and more stable economic developments. Like other small, open commodity economies, Norway also experienced that it was not possible to maintain a stable exchange rate as a nominal anchor. Inflation targeting was therefore introduced in 2001.

High and variable inflation usually accompanies instability in output and employment. But inflation should not be too low over time either. This is partly because the structure of the economy evolves over time. Demand for labour with different qualifications changes. Restructuring requires changes in real wages and relative wages. Nominal wages do not readily fall. With some measure of inflation, real wages and relative wages can be changed without reducing nominal wages. Some degree of inflation will oil the economic machinery.

In periods, it will be appropriate to stimulate the economy with low, or even negative, real interest rates. If inflation becomes entrenched at a very low level, the interest rate will be less effective as an instrument because it cannot be set below zero. If the economy is again exposed to unexpected negative disturbances, we will have little scope for manoeuvre.

Stability in output and employment
In the long term, output and employment are determined by the supply of labour, capital and technology and by the ability to adapt. Monetary policy can contribute to smoothing fluctuations in output and employment. Norges Bank weighs stable inflation against stable output and employment.

The output gap is a measure of the difference between the actual level of output and potential output. Potential output, which is the level of output that is consistent with inflation over time, is not directly observable and must be estimated. One simple method is to assume that potential output over time grows at trend because the labour force expands and productivity rises. Developments in the output gap provide a basis for assessing cyclical developments and can thus also shed light on domestic price and cost pressures in the economy.

It is difficult to know how high capacity utilisation is at any given time. Output and employment figures are often revised and do not therefore always present an accurate picture of the current economic situation. Norges Bank therefore also uses a number of other indicators to take the temperature of the Norwegian economy.

The period of strong expansion that began in 1997 came to an end in winter 2003. The Norwegian economy was hit by a pronounced downturn in the global economy. An economic turnaround has now occurred in Norway, with a soft landing after the long period of high domestic cost inflation and sluggish external activity. Output is showing a marked increase, but inflation is low.

Monetary policy easing
From spring 1999 to December 2002, the interest rate in Norway was fairly stable at between 5.5 per cent and 7 per cent. In other countries, the interest rate fell in 2000 and 2001 when the ICT and equity bubbles burst. The interest rate differential between Norway

and other countries widened due to cyclical divergence. The expansion continued for a longer period in Norway, with strong wage and cost inflation. The 2002 wage settlement resulted in very high wage growth for the fifth consecutive year.

A persistent downturn abroad, the likelihood of lower wage growth in Norway and a strong krone have led to reductions in the interest rate of 5 percentage points since December 2002. The sight deposit rate has been 1.75 per cent since March this year. Monetary policy easing has aimed to bring inflation up towards the target of 2.5 per cent and stabilise developments in output and employment.

The decline in interest rates since December 2002 has contributed to weakening the krone. Measured by an index of 44 trading partners (I-44), the krone depreciated through 2003 by almost 11 per cent from its strongest level in January of the same year. In 2004, the krone has fluctuated moderately around its current level. High oil prices and low interest rates abroad have curbed the effect on the krone of the fall in Norwegian interest rates. The krone has stabilised - though at a high level from the point of view of the inflation outlook.

Unexpected disturbances

The Norwegian economy was exposed to substantial, unexpected disturbances from autumn 2002 and into 2003. Global economic developments were an important factor behind the appreciation of the krone. In 2003, growth in the global economy moved on a different path and was substantially weaker than Norges Bank and other observers had expected. Weak developments in the global economy resulted in lower interest rates abroad and a wider interest rate differential between Norway and other countries. Developments in international equity markets and the risk of higher oil prices also contributed to strengthening the krone.

Activity in the world economy picked up in autumn 2003 from a very low level. After expanding sharply for several quarters, the US economy showed slower growth in the second quarter of this year. Economic growth has picked up from a low level in the euro area. Economic growth has also gained momentum in Sweden and the UK. Strong growth in the US and China exerted upward pressure on commodity prices in 2003 and the beginning of 2004. Oil prices have risen considerably during the summer. Several central banks have raised interest rates. Interest rate increases are expected in a number of countries.

Inflation is low

Consumer price inflation in Norway declined sharply through 2003. A number of factors appear to have contributed to the decline. The appreciation of the krone through 2002 pushed down import price inflation. At the same time, a change in trade patterns and external economic conditions have resulted in an unexpectedly sharp fall in import prices, even when measured in terms of what Norwegian importers pay in foreign currency. The change in trade patterns has made a considerable contribution to the sharp decline in prices for clothing, footwear and audiovisual equipment. Rapid technological advances have also pushed down prices for audiovisual equipment.

In Norway, competition has probably increased in retail trade and other service sectors in recent years. In the first round, heightened competition affects companies' profit margins. But enterprises will respond by reducing their costs. This will occur in part in the enterprise itself, but subcontractors will also be required to reduce their prices and enhance efficiency. Increased competition therefore usually triggers higher productivity growth in the economy. Low inflation may thus be matched by higher productivity.

Low inflation in the Nordic countries
Norway is not the only country where inflation has been low. In Sweden, underlying inflation fell sharply. Excluding energy prices, core inflation stands at 0.8 per cent in Sweden. Inflation has also slowed in Finland and Denmark. One explanation for this, common to all these countries, appears to be intensified competition, which has led to high productivity growth.

Real exchange rate and competitiveness
High wage growth over several years as from 1998 has eroded the competitiveness of the Norwegian business sector. The nominal krone exchange rate, as measured by the trade-weighted index, has now reverted to around the level prevailing in the mid-1990s, while labour costs in manufacturing have risen considerably more than among our trading partners in the same period.

However, the business sector is still feeling the effects of the loss in competitiveness that resulted from high wage increases. The exposed sector has been scaled back. Companies that are still in operation may be in a better position to cope with the high wage level. A more effective service sector may also have strengthened the export industry. Nevertheless, costs may limit activity and employment.

The international division of labour is shifting, and when faced with major changes it is a disadvantage for Norwegian business and industry that costs are high.

Credit growth
Total credit is expanding broadly in line with growth in nominal GDP. However, the composition of credit growth has been giving mixed signals in terms of interest-rate setting over the past year. Household debt accumulation is high, while it is low in the enterprise sector.

Household debt has increased sharply since 1994. The rise in the value of dwellings is one of the main factors behind growth in household debt. House prices have risen by an average of around 9 per cent over the past 10 years. High and persistent house price inflation may contribute to holding up credit growth even after prices have levelled off. Since only a portion of the housing stock is sold each year, there will for a long period be some dwellings that are sold at a higher price than when they were last sold. This contributes to sustaining credit growth at a high level. This probably reflects a structural adjustment to the deregulation of the housing and credit markets in the 1980s, after many households suffered financial distress in the wake of the relaxation. Homeowners with dwellings that have risen in value now have greater scope for taking up new mortgage-secured loans, using mortgage-equity withdrawal to finance consumption and other investments.

A persistently high rate of increase in house prices can in isolation engender expectations of a further rise and can thus prove to be self-reinforcing for a period and push up credit demand.

At the same time, the switch to a flexible inflation targeting regime reduces the possibility of exposing households to a double shock in the form of higher unemployment and higher interest rates, as was the case prior to the banking crisis in the beginning of the 1990s. If the economy is exposed to disturbances that may lead to higher unemployment, inflation will normally decline and interest rates will be lowered. High debt growth increases the vulnerability of households to economic disturbances.

As a result of low interest rates, the household interest burden will remain fairly low in spite of high debt growth. It may prove to be particularly challenging for borrowers to assess their debt-servicing capacity over time in a period when the interest rate is abnormally low. Such a low interest rate also places particular demands on banks in assessing the creditworthiness of borrowers.

The interest rate can be used to reduce credit demand. At present - with low interest rates abroad and a close link between domestic interest rates and the krone - a tighter monetary policy would restrain credit demand primarily because job security would be reduced as a result of a stronger krone.

Summary of the situation in the Norwegian economy
A turnaround in the Norwegian economy has occurred. The economy has experienced a soft landing after the long period of high cost inflation in Norway and sluggish external activity.

- Output has returned to trend and is now showing a marked rise.
- Employment has returned to trend and is rising.
- Unemployment is at the 1996-level, and is at the average for the 1990s.
- Wage growth is broadly in line with a level that is consistent with the inflation target given nomal productivity growth.
- Overall credit growth is balanced. Credit is expanding broadly in line with trend growth in nominal GDP.
- Labour costs in Norway relative to our trading partners are now broadly in line with a long-term average.
- The nominal krone exchange rate is in line with the average for the 1990s.
- The interest rate level is near the level prevailing among our trading partners.
- Inflation expectations are approximately consistent with the target.

In that respect, there is equilibrium in the Norwegian economy.

But the current inflation rate is low, and external and domestic interest rates are low. Lagged effects of the strong krone in 2002 are exerting downward pressure on inflation. At the same time, a change in trade patterns and external economic conditions are pushing down import prices, even when measured in terms of what Norwegian importers pay in foreign currency. In Norway, intensified competition appears to be resulting in high productivity growth, which is probably contributing to low inflation.

The outlook for the Norwegian economy
Last year, Norges Bank reported that inflation had declined to a low level, but we projected a gradual increase. We highlighted the uncertainty surrounding the inflation projection and indicated that inflation might remain low. Subsequently, inflation fell to an even lower level.

Structural adjustments in goods and service markets may imply low inflation also for a period ahead.

Growth is high in the Norwegian economy. Growth in the mainland economy primarily reflects higher activity in retail trade, the construction industry and the service sector. Imports are expanding at a brisk pace. There are prospects of continued strong growth in petroleum investment in 2005. Employment is rising, albeit still at a moderate pace.

Monetary policy influences the economy with long and variable lags. There is always uncertainty surrounding inflation developments. A very high oil price may also have an impact on the krone exchange rate. Historical deviations between projected and actual developments in the CPI-ATE provide an illustration of the uncertainty surrounding the inflation projections.

The fall in the value of the krone through 2003, low interest rates and solid growth in the real economy will gradually push up inflation. Price developments in recent months have, nevertheless, increased the risk that inflation will remain low for a longer period.

Thank you for allowing me to make the introductory statement at this hearing.