Monetary policy and business cycles

Speech by Deputy Governor Jarle Bergo, Kunnskapsparken Bodø, 25 September 2003

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 17 September and on previous speeches.

The operational target of monetary policy as defined by the Government is inflation of close to 2.5 per cent over time.

The inflation target provides economic agents with an anchor for their decisions concerning saving, investment, budgets and wages. The inflation target also provides a framework for monetary policy's contribution to stabilising output and employment. This intention is also expressed in the Regulation on Monetary Policy. High demand for goods and services and labour shortages normally point to higher inflation. When interest rates are increased, demand falls and inflation is kept at bay. When demand is low and unemployment rises, inflation will tend to slow. Interest rates will then be reduced.

Norges Bank sets the interest rate so that future inflation will be equal to the inflation target of 2½ per cent. The interest rate has been reduced since December last year in response to the change in the inflation outlook. This was the result of weaker cyclical developments in the world economy and a sharp drop in interest rates internationally. In addition, the Norwegian business sector has felt the effects of the high Norwegian cost level and the strong krone exchange rate. Public agencies have also had to adapt activities as a result of last year's wage settlement. The weak prospects abroad and at home have in turn had an impact on the Norwegian labour market and the outlook for wage growth and inflation in the years ahead.

The mandate implies that the interest rate must be adapted to the outlook for the Norwegian economy. If it appears that inflation will be higher than 2½ per cent with an unchanged interest rate, the interest rate will be increased. If it appears that inflation will be lower than 2½ per cent with an unchanged interest rate, the interest rate will be reduced. Normally, this orientation of monetary policy will also contribute to stabilising output and employment.

The impact of monetary policy occurs with a lag. The current inflation rate does not provide sufficient information to determine the level at which interest rates should be set now. Our analyses indicate that a substantial share of the effects of an interest rate change will occur within two years. Thus, two years is normally a reasonable time horizon for reaching the inflation target.

The interest rate influences inflation indirectly via domestic demand for goods and services and via its effect on the exchange rate. When the interest rate falls, it is less profitable for households to save, and they will therefore make purchases now rather than wait until later.

Borrowing also becomes less costly, and investment also rises. Higher demand in turn leads to a higher rise in prices and wages. Lower interest rates make it less attractive to invest in the Norwegian krone and for Norwegian enterprises and households to raise loans in foreign currency. Therefore, lower interest rates will normally lead to reduced capital inflows and a depreciation of the krone. This makes imported goods more expensive. In addition, a weaker krone increases activity, profitability and the capacity to pay in the internationally exposed sector.

Activity in the economy moves in waves. For the Norwegian economy, the 1980s was a period of relatively wide fluctuations in activity, with periods of high inflation. The mid-1990s represents a period of stable and solid growth. In contrast to the situation in the previous decade, inflation was low and stable.

At the beginning of the 1990s, the Norwegian economy was in a deep recession. Production was far below capacity. When growth in the economy picked up, capacity utilisation increased. The output gap shows the difference between actual GDP and the level indicated by trend growth - estimated at close to 2½ per cent in Norway. Around 1996, there was full capacity utilisation, and the output gap, as we normally measure it, closed.

Subsequently, growth in labour costs picked up, and the rise in prices for goods and services produced for the Norwegian market accelerated. The upturn peaked in 1997, with mainland GDP growth approaching 5 per cent. In 1997 and 1998, the economy shifted from an upturn with high growth rates to an expansion with lower growth but low unemployment, labour shortages in many sectors and strong growth in labour costs.

Capacity utilisation in the mainland economy has subsequently fallen again and is now on a par with the level in the years 1995-1997, before cost inflation accelerated. The output gap has again closed. At the same time, wage growth has dropped to a more sustainable level.

Labour costs rose more rapidly in Norway than among its trading partners due to the high pay increases negotiated by the social partners during the period of strong economic expansion after 1997. Until 2000, this was counteracted by the depreciation of the krone. Companies with income in foreign currency could cover the higher labour costs with the increased revenues which were a result of the weaker krone.

When the krone began to appreciate, however, it did not take long before relative labour costs measured in a common currency rose sharply. Despite this development, the strong wage growth continued.

This contributed to a deterioration in the exposed sector's competitiveness. Despite a pronounced downturn among many of our trading partners last year, annual wage growth in Norway increased to 5¾ per cent. Wage drift remained surprisingly high through the autumn of 2002, especially in some manufacturing sectors, partly as a result of local settlements.

Due to the depreciation of the krone this year, it now appears that competitiveness is improving somewhat compared with last year. Wage growth has also slowed to a more sustainable level. However, cost competitiveness is still weaker than the average for the past 30 years.

The global downturn started in 2000 and through 2001, the interest rate in the US was sharply reduced to stimulate growth. For a long period, a relatively rapid recovery was expected. During the autumn of last year, it became clear, however, that growth would remain subdued for a longer period.

Changes in the economic outlook are clearly expressed in implied forward rates. In the US, these expectations have been adjusted downwards considerably since summer 2002. Last summer, market participants expected the key rate in the US to be increased to about 4 per cent towards the end of 2003. The interest rate is now believed to have reached its lowest level and is expected to remain at 1 per cent until the end of 2003, with only a gradual rise after that.

The lower projections for growth reflect the effect on the world economy of a number of negative shocks, such as the war in Iraq and the SARS virus. It took longer than first expected to correct imbalances created by an overoptimistic outlook in sectors such as the IT industry. High oil prices may also have contributed to curbing the growth rate.

GDP growth in important European countries has been low or negative for some time. In the Netherlands, GDP has fallen for three consecutive quarters, and Germany has recorded a contraction over the last two quarters. France's GDP showed growth in the first quarter and a decline in the second quarter of this year. For the euro area as a whole, preliminary figures show that GDP fell by 0.1 per cent in the second quarter. Some consumer and business confidence indicators have recently shown signs of improvement, and the EU Commission's estimates point to a slight increase in growth in the next few quarters. There are, however, no clear signs of an imminent and rapid recovery.

The key rate in the euro area has been reduced to 2 per cent. Interest rates are expected to remain at 2 per cent to the end of 2003, before rising slightly next year.

International business cycles affect the level of economic activity in Norway through a number of channels, including the interest rate differential and the krone exchange rate.

Subdued economic growth internationally and high growth in Norway resulted in a wide interest rate differential between Norway and its trading partners. This made it very profitable to invest in the Norwegian krone, and the krone exchange rate appreciated. The appreciation of the krone and high wage growth led to a considerable deterioration in the competitiveness of Norwegian enterprises.

Through 2003, the interest rate differential has narrowed as a result of monetary policy easing. This has also contributed to a substantial depreciation of the krone.

In Norway, internationally oriented business sectors, such as the ICT sector and the travel industry, have been particularly affected by weak global developments. Expectations concerning future earnings have been revised downwards substantially in these sectors. This has led to cost cuts and redundancies. Combined with a deterioration in competitiveness and lower activity in manufacturing, this has resulted in rising unemployment in the last year. Public agencies have had limited opportunities to increase service production because wages have risen. Some municipalities and other government agencies have reduced the number of employees.

While real economic activity has declined and unemployment has increased, inflation in Norway is now low. The rise in consumer prices adjusted for taxes and excluding energy products (CPI-ATE) has slowed, primarily due to developments in prices for imported consumer goods. Low inflation is a consequence of the appreciation of the krone throughout last year and low inflation abroad. The rise in prices for domestically produced goods and services has also slowed. This particularly applies to prices for domestically produced goods influenced by world market prices.

In August, the year-on-year rise in the CPI-ATE was 0.9 per cent, after having been down to 0.7 per cent one month earlier. This was slightly lower than projected in the last Inflation Report and considerably lower than the inflation target of 2.5 per cent. In mid-September, Norges Bank submitted a report to the Ministry of Finance. This report carefully examines the reasons for the low level of inflation and the measures that have been implemented to bring inflation back up to target.

There are still prospects of low inflation for some time ahead. Developments in other countries indicate that prices for imported goods and services, measured in the producer countries' currencies, will not rise appreciably. It also takes time for the effects of last year's appreciation of the krone to dissipate. However, this year's krone depreciation will gradually have an affect on inflation and thus contribute to higher inflation.

The analysis in the June Inflation Report showed that a reduction in the sight deposit rate towards 3 per cent, combined with some depreciation of the krone, could bring inflation up towards the target at the two-year horizon[1]. The prospect of more moderate wage growth ahead could provide a basis for an even lower interest rate and a weaker krone without the projections for inflation exceeding 2.5 per cent in the period.

With reduced pressures in the economy and an inflation outlook that is below target at the two-year horizon, Norges Bank has reduced the key rate a number of times in the last year. This summer the interest rate has been reduced in larger steps than has been customary. Interest rate reductions have been an important element in preventing inflation expectations from taking hold at too low a level. The reductions in the interest rate will also contribute to pushing up growth in the economy.

There was a decline in mainland GDP this past winter. Subsequently, it appears that growth has picked up somewhat, but investment activity in mainland Norway is still low. Investment in the petroleum sector is rising, but a large portion of the increase in demand is being met by imports. Public consumption rose sharply in 2002, but the public sector is providing little stimulus to the economy this year. In spite of relatively high growth in nominal budget ceilings, high wage growth gives little room for increased activity. It is primarily private consumption that is making a positive contribution. More balanced growth might be desirable, but households have strengthened their financial position in recent years at the expense of private and public enterprises. Therefore, these sectors' capacity to push up growth will be somewhat reduced in the period ahead. We expect that growth in private consumption will gradually contribute to higher employment and increased investment in mainland enterprises. The interest rate reductions will underpin these developments.

Growth in the global economy is also expected to accelerate and stimulate growth in Norway. The recovery of the US and Japanese economies appears to be somewhat more swift and more pronounced than expected. The recovery in the US has not, however, led to higher employment, adding to the uncertainty about the strength and duration of the recovery. In Europe, the economy is still marked by stagnation, and projections for growth in 2003 have been revised downwards a number of times. A moderate upturn is expected in 2004, but activity will remain at a low level.

Even though Norges Bank is forward-looking in its conduct of monetary policy, thorough knowledge of the current state of the economy is extremely important. An up-to-date and correct picture of the current situation is necessary to make accurate projections for the period ahead.

In autumn 2002, Norges Bank established a regional network as a tool to gauge the level of activity in the Norwegian economy.

Official statistics and evaluations of developments in financial markets will continue to be the main basis for our assessments, but due to the time lag and revisions of such statistics, supplementary information is useful.

The regional network provides up-to-date information on the state of the Norwegian economy. Regular communication with local contacts in Norway's business and community life provides us with information that supplements available official statistics. It also provides us with supplementary information on areas not covered by official statistical sources, and we learn which issues are of particular concern to enterprises.

The network consists of companies, organisations and municipalities throughout Norway. We will be having six rounds of talks each year with business and community leaders concerning financial developments in their enterprises and industries, with about 200 visits in each round. The selection of contacts represents the production side of the economy, both industry-wise and geographically.

In the course of 2003, the number of contacts in the network will rise to about 1000 persons. These individuals will be contacted once or twice a year.

Kunnskapsparken in Bodø conducts the contact meetings in Region North.

In general, our contacts in Region North reported at the end of August and the beginning of September that developments continue to be sluggish.

The fishing industry is still experiencing difficult times, even though some enterprises have reported a slight increase in demand for certain species and products.

Companies supplying goods and services to the fisheries and aquaculture sector are experiencing a decline in demand and output and a number of companies only have a few service orders.

The household service sector is reporting a small increase in demand, whereas companies' demand for services is generally stagnant or falling slightly.

The public sector is reducing the number of employees, while retail trade and the construction sector are planning a slight increase in the number of employees.

The rise in costs in the last few years has not fed through to prices due to intense competition, both from abroad and from other market participants in Norway. Instead, enterprises has reduced activity and implemented extensive efficiency- enhancing measures.

The public sector employs more than one-third of the labour force in Norway. In Northern Norway, public sector employees account for close to 45 per cent of the labour force.

The primary industries are important for the counties in Northern Norway, especially the utilisation of the abundant fish resources in the coastal areas. A large part of the fishing industry is export-oriented and is increasingly competing with low-cost countries. These industries will be vulnerable when the rise in domestic costs is high.

There are wide regional variations in unemployment. At the end of July, the number of registered unemployed in Northern Norway came to 4.4 per cent of the labour force, which is slightly higher than the national average of 4.1 per cent.

Even though the region has somewhat higher unemployment than the national average, the rise in unemployment in Northern Norway has been relatively low in the last year. Unemployment has only risen half as much in Northern Norway as in the rest of the country. The number of unemployed has risen least in the county of Finnmark in the last year. This is probably related to the industry structure which is characterised by a relatively high share of employees in the public service sector.

As I have mentioned, a look at the current situation in this part of the country and similar reports from the other regions represent important information in the work on setting interest rates.

The short-term nominal interest rate in Norway has now reached a historically very low level. The real interest rate is also low, but not nearly so low as in the beginning of the 1980s when inflation was high.

Without a considerable easing of monetary policy, inflation might have been too low for an extensive period. This may in turn lead to expectations of continued very low inflation. In such a situation, it may be more demanding to increase economic activity. It was therefore appropriate to reduce the interest rate considerably.

Since December last year, monetary policy has been eased to a greater extent and more rapidly than has been customary. Following this phase of substantial easing, uncertainty with regard to economic developments in the period ahead may be somewhat greater than normal.

If households assume that interest rates will remain low, private consumption may increase substantially, and the rise in house prices and household borrowing may again accelerate. The risk of stronger growth in household demand must be weighed against the sluggish developments in the business sector. Despite the depreciation of the krone, enterprises' competitiveness is still rather weak after many years of high wage growth.Vacancy rates for commercial premises are high and rents have fallen.

Another risk is that wage growth may accelerate again, as it did following the interest rate reductions in 1999. This risk is also being reduced by a slacker labour market. Unemployment in 2004 will probably be on a par with the level in 1996 and 1997. Annual wage growth in these years was a little less than 4½ per cent.

The low pay increases in this year's wage settlement may indicate that the social partners are now placing more weight on the negative effects of large pay increases on future developments in interest rates, the krone exchange rate and employment in contrast to what appeared to be the case in the past few years. In the light of experience from 2002, it must be assumed that public agencies will be more cautious in future wage settlements. The labour market outlook underpins expectations of moderate wage growth.

Developments in the krone exchange rate represent another source of uncertainty. The relationship between the krone exchange rate and the interest rate differential against other countries is not necessarily stable over time. Themes in international financial markets change. However, the depreciation of the krone this year is contributing to stabilising inflation and activity in the economy. We may not yet have seen the full effects of the interest rate reductions on the krone exchange rate. At the same time, the krone may be influenced by fiscal policy and the outlook for wage growth.

Norges Bank has no set target for the level of the exchange rate. Developments in the krone are nevertheless of considerable importance in interest rate setting. The response to a change in the exchange rate will depend on its expected impact on inflation. This requires an evaluation of the reasons for the duration of the change. Short-term fluctuations in the krone tend to have very limited effects on economic developments, while long-lasting changes may have an impact.

Norges Bank has mainly based projections in the baseline scenario in its inflation reports on a constant exchange rate equal to the average for the previous three months, and in some cases the average for the previous month. Using these averages, very short-term variations in the krone exchange rate will have less effect on the exchange rate assumption. A more long-lasting change in the krone exchange rate will, on the other hand, be taken into account over time and will gradually have an effect on the inflation projection and on interest rate setting.

Norges Bank's Executive Board sets the interest rate with a view to achieving the inflation target of 2½ per cent. The inflation target also provides a framework for stabilising output and employment. When setting the interest rate, the Executive Board seeks to strike a balance. On the one hand is the consideration of bringing inflation up to target and stimulating growth in the Norwegian economy. On the other hand, we must consider the risk of new pressures in the Norwegian economy when looking further ahead. Since December 2002, we have found it appropriate to reduce the interest rate to a low level. At the last monetary policy meeting on 17 September, it was decided to reduce the interest rate to 2.5 per cent. According to Norges Bank's assessment, with an interest rate of 2.5 per cent, the probability that inflation two years ahead will be higher than 2½ per cent is the same as the probability that it will be lower.

Thank you for your attention.

Footnotes

[1]Based on an assumption concerning forward rates and a gradual depreciation of the exchange rate