Monetary policy and the economic situation

Speech by Governor Svein Gjedrem at the Norwegian University of Science and Technology, Trondheim, 2 September 2003

The text below may differ slightly from the actual presentation.

The speech is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 13 August 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 is a vehicle 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. The weak prospects at home and abroad 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 unchanged interest rates, the interest rate will be increased. If it appears that inflation will be lower than 2½ per cent with unchanged interest rates, the interest rate will be reduced. This orientation of monetary policy will normally 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 interest rates rise, it becomes more profitable for households to save, and they will therefore postpone consumption. Borrowing also becomes more costly, with an associated decline in investment. Lower demand in turn curbs the rise in prices and wages. Higher interest rates make it more attractive to invest in NOK and borrow in foreign currency. Therefore, higher interest rates normally lead to an appreciation of the krone. This makes imported goods cheaper. In addition, a strong krone reduces activity, profitability and the ability to pay in the internationally exposed sector.

Expectations in the US as to how far the interest rate will fall have been adjusted downwards considerably since summer 2002. Last summer, market participants expected the key rate in the US to be increased to about 5 per cent towards the end of 2004. Now interest rates are believed to have reached their lowest level and are expected to remain at 1 per cent until the end of 2003, with a gradual rise to about 2.5 per cent in 2005.

Clearer signs of the expected upswing have emerged recently, however. GDP grew by 3.1 per cent (seasonally adjusted, annual rate) in the second quarter. Optimism among participants in the financial markets is increasing; both equity prices and long-term interest rates have risen.

Despite improvement in the US economy, some aspects still give rise to uncertainty as to whether the expected upswing will be sustained. Capacity utilisation in manufacturing is still low. The household saving ratio is low and household debt is high. The current account is showing a large deficit.

At its monetary policy meeting in August, the Federal Open Market Committee decided to keep its target for the federal funds rate unchanged at 1 per cent. The Committee perceived that the upside and downside risks to the attainment of sustainable growth for the next few quarters were roughly equal. The Committee judged that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future. In these circumstances, the Committee believed that policy accommodation can be maintained for a considerable period.

Asia is showing signs of recovery. China is leading the field with economic growth approaching 10 per cent and Thailand is showing strong growth. But the picture is not all positive. South Korea has experienced slower growth this year. South Korea is one of the countries that is particularly affected by the competition from China. In Japan, where growth has been low for a long period, there are indications that growth is picking up, although it is still too early to say whether it is sustainable.

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

GDP growth in major European countries is low or negative. In the Netherlands, GDP has dropped for three consecutive quarters, and Germany has recorded a decline over the past 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 indicate zero growth in the second quarter. Some consumer and business confidence indicators have recently shown signs of improvement, and the EU Commission's estimates point to moderate growth in the next few quarters. There are, however, no clear signs of an imminent and rapid recovery.

Among our trading partners as a whole, economic developments over the past year have been far weaker than Norges Bank and others, both analysts and international organisations, had expected. Growth projections for 2003 have been revised downwards substantially over the past year, reflecting the effect on the world economy of a number of negative shocks such as the war in Iraq and SARS.

Global growth is still expected to pick up gradually towards a more normal level, but the upswing may come at a later stage than previously assumed. However, we cannot rule out the possibility that the global economy is facing a relatively long period of stagnation with low and possibly falling inflation. This risk is reflected in the low short-term interest rates in the US, Europe and Japan. Long-term interest rates have edged up again recently. This may be an indication that financial market participants are now somewhat more optimistic and expect that the economic policy stimulus will have the desired effect.

In spite of weak economic developments, oil prices have remained high. Low levels of production in Iraq have contributed to holding up oil prices. Strikes and production problems in Venezuela and Nigeria have also played a role. These developments may keep oil prices high until growth in the global economy returns to normal. The oil industry will then have come through this period of sluggish growth in the global economy since 2000 without a fall in revenues. This has, in isolation, curbed the effects of the international downturn on Norway. However, the situation, as a whole and with regard to oil prices, is still highly uncertain.

Weak external developments have in particular had negative spillover effects on the Norwegian economy through the appreciation of the krone, the fall in equity prices last year and lower demand for Norwegian exports.

The krone exchange rate is the price of our currency measured in terms of a foreign currency. Developments in other countries are just as important for the krone as developments in the Norwegian economy. The krone has been strong. As a result, prices for imported goods have fallen. This has contributed to low inflation despite strong wage growth over a period of several years.

Our analyses indicate that the most important reason for the appreciation of the krone from May 2000 to the end of 2002 was the positive and widening interest rate differential. Combined with the interest rate differential, the fall in equity prices and reduced fluctuations, or volatility, in foreign exchange markets contributed to the appreciation of the krone last year. The effect of the interest rate differential on the krone has been amplified by developments in international capital markets. Part of the appreciation in 2002 may also be due to higher oil prices. In a highly uncertain situation and with fears of war in Iraq, the Norwegian krone, buoyed by a relatively high interest rate and oil wealth, may have been regarded as an attractive alternative. Investment in NOK may have been considered a good hedge against a downturn in the world economy as a result of fears of war and high oil prices. Since December last year, the interest rate differential between Norway and other countries has narrowed by about 3 percentage points. Since the beginning of 2003, the krone measured in terms of the trade-weighted exchange rate index (TWI) has depreciated by 11 per cent.

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, costs increased and prices for goods and services produced for the Norwegian market accelerated. The upturn peaked in 1997, with 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. Unemployment has increased again since 2001. Capacity utilisation in the mainland economy has fallen again from a high level 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.

However, growth in the economy stalled last winter. It has therefore been appropriate to reduce interest rates markedly.

Even though the krone has depreciated this year, competitiveness is still fairly weak. In the period 1996-2003, competitiveness in Norwegian manufacturing has deteriorated by about 13 per cent. The deterioration is solely ascribable to higher growth in labour costs in Norway than among our trading partners. The krone measured in terms of the trade-weighted exchange rate index (TWI) is currently at about the same level as in 1996. Compared with the average for the last 30 years (1970-2003), wage growth has contributed to a deterioration in competitiveness of 15 per cent. In the years around the turn of the millennium, the depreciation of the krone veiled the underlying deterioration in competitiveness. In May 2000, the krone exchange rate reached its lowest level in six years. In the following period and until the end of 2002, the krone appreciated, and the effect of high wage growth gradually came into evidence in overall corporate results. Results last year were affected by a particularly strong krone in the second half of the year. The krone exchange rate, measured in terms of the TWI, has now returned to the level of the mid-1990s, while the business sector is still grappling with the high level of costs that has built up since 1998. Changes in the krone exchange rate have proved to be reversible, but the loss of competitiveness and jobs caused by the relatively high level of domestic wage growth is more difficult to recoup.

In recent years, labour costs have accounted for an increasing share of corporate earnings. In 2002, labour costs accounted for more than 90 per cent of total factor income in manufacturing.

The increase in wage shares is affecting corporate behaviour. The demand for labour is declining. Credit demand and investment in the enterprise sector are low. At the same time, the commercial property market is weak. Vacancy rates for commercial premises are high and rents have fallen. This will have an impact on investment in the period ahead.

Lower interest rates will normally result in higher inflation, partly because the krone depreciates, and partly because of a rise in demand. Enterprises will thus be able to increase their earnings. Business sector activity is stimulated most effectively by low interest rates and a weak krone.

Due to the past few years' wage settlements, households have strengthened their financial position at the expense of private and public enterprises. House prices have edged up after stagnating earlier this year. Household borrowing has moderated somewhat, but is still high. Against this background, growth in private consumption is expected to be fairly high in the period ahead. Consumer spending on goods is rising, pointing towards growth in private consumption this year on a par with our projections in the June *Inflation Report*.

Mainland GDP is projected to rise less than trend growth this year and to reach trend levels in 2004[1]. In 2005, GDP growth is projected to be higher than trend growth. Investment activity in mainland Norway is low. Investment in the petroleum sector is rising, but a large share of the increase in demand is being met by imports. Public consumption increased sharply in 2002, but there will be little stimulus to the economy from the public sector this year. Growth will mainly be fuelled by private consumption in the second half of this year and into 2004. We expect that investment in mainland enterprises will gradually pick up from a low level.

In order to set an appropriate interest rate, it is important to be be able to form a reasonably accurate picture of the economic situation. Economic statistics are the most important source of information, but they are published with a lag and some of the figures are revised frequently.

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

The network consists of companies, organisations and municipalities throughout Norway. In the two rounds of talks in connection with *Inflation Report* 2/03, 450 contacts were interviewed. 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, who will be contacted once or twice a year. The Department of Economics at the Norwegian University of Science and Technology is responsible for the network in Trøndelag county and conducts contact meetings.

Official statistics and current market information will continue to be the main basis for our assessments, but due to the time lag and revisions of 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 additional information on areas not covered by official statistical sources, and we learn which issues are of particular interest to enterprises.

Information received from the regional network supported the picture presented in the June *Inflation Report*: enterprises are reducing costs while households' financial position is strong. We are waiting to see if the results of the current round of talks will point to increased optimism in the business sector and in public entities or if the prospects for the future continue to be regarded as somewhat negative.

Inflation is low in Norway. 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 due to 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 is particularly the case for domestically produced goods influenced by world market prices. Domestic price inflation has nevertheless remained close to 3 per cent, due to high wage growth over several years.

In July, the year-on-year rise in the CPI-ATE was 0.7 per cent, which is lower than projected in the June *Inflation Report* and substantially lower than the inflation target. There are also prospects that inflation will be low for some time ahead. 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 two years ahead[2]. More moderate wage settlements in the future would provide a basis for even further monetary policy easing and a weaker krone[3]. Without considerable monetary policy easing, inflation might have remained too low for an extensive period.

The short-term nominal interest rate in Norway has now reached a historically very low level. Interest rates have not been lower since the first nine to ten years following the Second World War. The real interest rate is also low, although by no means as low as it was when inflation plagued Norwegian savers in the 1970s and 1980s.

The low interest rate must be viewed against the risk of persistently low inflation both in Norway and in other countries. So far, indicators of inflation expectations do not point to any substantial deviation from the inflation target of 2½ per cent. However, if inflation should remain too low for an extensive period, there is a risk that expectations of continued very low inflation will be generated. It may then prove difficult to fuel economic activity by stimulating demand. A marked easing of monetary policy has therefore been appropriate. The inflation target is symmetrical. It is equally important to avoid an inflation rate that is too low as it is to avoid an inflation rate that is too high.

Capacity utilisation in the Norwegian economy is now neither abnormally high nor abnormally low. However, available statistics indicate that economic growth came to a halt during the winter. A global upswing will contribute to stronger growth in Norway. Growth is sluggish already, however, with stagnation in many business sectors. Since inflation is also low, a low interest rate is appropriate now.

But it is always a question of weighing one consideration against another. 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 has been somewhat greater than normal. With the easing that has been implemented, we must be particularly alert to changes in private consumption, wage growth and the krone exchange rate.

If households expect the interest rate to remain low, private consumption may increase more than has been assumed. House prices and household borrowing may again accelerate. However, increased slack in the labour market and declining migration to the largest towns will reduce these effects. The risk of stronger growth in household demand must be weighed against the sluggish developments in the business sector. Even though the krone has depreciated from its strong level at the beginning of the year, competitiveness is still relatively weak after many years of high wage growth. In addition, 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 slackening 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 also indicate that the social partners have placed more weight on the effects of pay increases on future developments in interest rates, the krone exchange rate and employment. In addition, activity in public and particularly sheltered industries is probably still feeling the impact of the expensive pay increases last year and earlier years. We expect that in light of the experience gained in 2002, public entities will exercise more caution in future wage settlements.

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 shift. 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 on the krone exchange rate of the interest rate reductions that have been implemented. At the same time, the krone can be influenced by fiscal policy and the outlook for wage growth.

Norges Bank's Executive Board sets the interest rate with a view to achieving the inflation target of 2½ per cent. The inflation target is also a vehicle for monetary policy's contribution to stabilising output and employment. When setting the interest rate, the Executive Board seeks to achieve a balance. The objective of stimulating growth in the Norwegian economy and achieving the inflation target is weighed against the risk of new pressures building up in the economy over the long term. Since December 2002, we have judged that to achieve this balance it was appropriate to reduce the interest rate to a low level. At the last monetary policy meeting on 13 August, it was decided to reduce the interest rate to 3.0 per cent. With an interest rate of 3.0 per cent, the Executive Board's assessment remained unchanged, i.e. that the probability that inflation two years ahead will be lower than 2½ per cent is greater than the probability that it will be higher.

Thank you for your attention.

Footnotes

[1]Projection in Inflation Report 2/03 based on assumptions concerning forward rates and a gradually declining krone exchange rate.

[2]Based on assumptions concerning forward rates and a gradually declining krone exchange rate.

[3]Based on assumptions concerning forward rates and a gradually declining krone exchange rate, and an assumption that monetary policy easing will not translate into stronger wage growth.