The monetary policy response to the economic outlook

Address by Governor Svein Gjedrem, Hamar, 21 May 2003

The address is based on previous speeches and on the assessments presented at Norges Bank's press conference following the monetary policy meeting on 30 April. Please note that the text below may differ slightly from the actual presentation.

The operational objective of monetary policy as defined by the Government is inflation of close to 2½ per cent over time.

Norges Bank sets the interest rate so that future inflation will be equal to the inflation target of 2½ per cent. The interest rate reductions last winter and this spring were a response to changes in the inflation outlook as a result of slower global economic growth and a sharp decline in international interest rates. In addition, the Norwegian business sector is feeling the effects of the high Norwegian cost level. Growth in domestic demand has also slowed. Household purchasing power has been reduced as a result of higher electricity prices. The weak prospects at home and abroad are in turn having an impact on the Norwegian labour market and the outlook for wage growth and inflation in the years ahead. Even though the krone has depreciated this year, it is still fairly strong, contributing to a fall in prices for imported goods and services.

The inflation target provides economic agents with an anchor for their decisions concerning saving, investment, budgets and wages. Households, businesses, public entities, employees and employers can base decisions on the assumption that inflation in Norway will be 2½ per cent over time.

The inflation target is a vehicle for allowing monetary policy to stabilise developments in 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.

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 considerable and variable lags. The current inflation rate does not therefore 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. Two years is thus a reasonable time horizon for achieving 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 consumption will therefore be postponed. Similarly, borrowing becomes more expensive, and investment will decline as a result. Lower demand then 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 stronger krone reduces activity, profitability and the ability to pay in the internationally exposed sector.

Major economies such as the US, Germany and France are struggling with stagnation and fears of recession. Sluggish developments have led many countries to set very low interest rates in an attempt to stimulate growth.

The business cycles in Norway and other countries have been desynchronised. While the turnaround abroad took place two years ago, the Norwegian economy continued to show a high level of activity. Towards the end of the upturn, the economy was facing labour shortages, higher wage growth and a sharp increase in household consumption and debt. Interest rates had to be kept at a high level in Norway. This led to a widening of the interest rate differential against other countries. The main explanation for the wide interest rate differential is that interest rates abroad are at a historically low level.

Business cycles have also diverged in other ways. The turnaround abroad, which started in the US in 2000, seems to have been related in particular to overinvestment in the business sector, exaggerated expectations concerning future earnings and equity market bubbles that burst. There have been examples of this in Norway too, and the Norwegian economy has over time been influenced by weak external developments. However, other factors seem to have been more instrumental in generating the turnaround in the Norwegian economy. The high rate of economic expansion is now beginning to ebb away as a result of self-regulating mechanisms and a tightening of monetary policy following overheating in the labour market. Wages and costs rose sharply in Norway but more moderately in other countries, even during the period of strong growth in the second half of the 1990s.

In the course of the autumn and winter, it became apparent that developments in the global economy are weaker than we and many others had expected. Many central banks have responded by reducing interest rates further. Interest rates in the US, Europe and Japan are unusually low. Interest rates in the US have not been at such a low level since the 1960s.

In the last half of the 1990s, when both Japan and Europe experienced sluggish growth, the US functioned as a global growth engine. This period of strong growth in the US peaked in 2000, and the following rapid deterioration in the economy prompted the Federal Reserve to reduce the interest rate from 6½ per cent in May 2000 to today's record low 1¼ per cent. Weak developments are reflected in expectations of low interest rates ahead. Interest rate expectations in the US have been lowered considerably since summer 2002. In the summer, market participants expected interest rates to rise fairly rapidly. In the autumn, there were expectations of a gradual increase in interest rates. Now, the federal funds rate is expected to remain below 1¼ per cent throughout 2003.

Expectations concerning future interest rates are also considerably lower now in Europe.

The period of strong economic expansion in the US was driven by strong growth in investment. With low interest rates, households had less incentive to save in banks (and they chose instead to invest in the equity market). At the same time, costs related to corporate investment were reduced, leading to a sharp rise in lending and credit-driven investment growth. This resulted in over-capacity, particularly perhaps in the telecommunications and IT sectors. With the absence of accelerating inflation, the level of activity in the economy remained high, and low interest rates at the end of the 1990s may have contributed to maintaining a high level of investment. When share prices fell in autumn 2000 and spring 2001, investment came to a halt. Investment as a share of output and demand is now lower than the average for the past 20 years, but now appears to be stabilising. It may therefore take some time before the turnaround occurs and investment picks up again.

Strong investment growth has contributed to a build-up of overcapacity in US manufacturing. Capacity utilisation in manufacturing is low[1]. Low capacity utilisation also reflects the overinvestment that took place at the end of the expansionary period.

The household saving ratio has picked up somewhat since 2000, probably as a result of the decline in the equity market - although it is still low. Similarly, the federal government budget deficit - as a result of expenditure in connection with war combined with substantial tax reductions - will increase. The current account deficit in the last quarter of 2002 was equivalent to 5¼ per cent of GDP. The low saving ratio and the substantial current account deficit has contributed to a depreciation of the US dollar.

Conditions in the US today are more conducive to growth than they were six months or a year ago. The low interest rate will support an increase in both consumption and investment. Corporate profits and financial balances have improved. Companies' liquidity is solid. At the same time, however, it is uncertain how far shortfalls in corporate pension schemes[2] will weaken growth impulses. And with low capacity utilisation, it may take time before investment gains momentum.

As mentioned earlier, the driving forces behind the Norwegian business cycle have differed from those in other countries. In Norway, the business cycle has followed a course more similar to previous fluctuations, with a sharp rise in household demand, labour shortages and strong wage growth.

Measured in a common currency, labour costs for Norwegian industrial workers have increased by a total of 19 per cent more than was the case for our trading partners in the period 1996-2002 (13 per cent due to wage growth and 6 per cent due to the appreciation of the krone). In the years around 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 subsequent period up to end-2002, the krone appreciated, and the effects of high wage growth have gradually come into evidence in company accounts.

High labour costs measured in a common currency have weakened profitability in the business sector. This is the reason for the current cost cuts, the decline in employment and the increase in unemployment.

For a long time, a stable exchange rate and the level of cost inflation among our trading partners provided an anchor for wage determination in Norway. In order to maintain competitiveness, wage growth in Norway had to be on a par with that of trading partners. Over time, growth in real wages must be consistent with growth in labour productivity. An inflation target of 2½ per cent and trend productivity growth of around 2 per cent, according to updated national accounts figures, imply annual nominal wage growth of about 4½ per cent. These figures are consistent with developments in the 1990s, when wage growth averaged 4½ per cent. This resulted in an inflation rate of 2½ per cent. The krone exchange rate was stable.

The output gap shows the difference between actual production (GDP) and trend growth - estimated at close to 2.5 per cent in Norway. At the beginning of the 1990s, the economy was in a deep recession. Production was well below capacity. When growth in the economy picked up, capacity utilisation increased. The output gap closed around 1996. From then on, costs increased and the rise in prices for goods and services produced for the Norwegian market accelerated. The upturn peaked in 1997, with GDP growth approaching 5 per cent. The pace of such a strong upturn could not be sustained. 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.

The period of strong expansion has ebbed away in the course of the past year. Winter 2002 marked the turnaround in the Norwegian economy. Growth in the mainland economy is now lower. Unemployment is approaching the average for the 1990s. Industrial leaders are pessimistic. Companies report a decline in production, employment and orders for both the export and domestic markets. Many companies have relocated or have plans to relocate all or some of their production operations abroad. In particular, enterprises producing capital goods are experiencing problems.

The number of bankruptcies has increased sharply. The number of bankruptcy petitions is the highest in nine years. If we disregard personal bankruptcies, there has been an increase of 32 per cent from the first quarter of 2002 to the first quarter of 2003 - 200 more than a year ago. The largest increase in the first quarter is in retail trade and the property management and commercial services sector, while manufacturing and the construction sector accounted for the largest increase in the previous quarter. The number of bankruptcies increased in all counties compared with 2002, with the sharpest increase in Hordaland, Buskerud and Oslo (161, 111 and 18 per cent respectively from 2001 to 2002). Oslo accounted for most bankruptcy petitions, with 249 in the first quarter.

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 contact rounds in connection with Inflation Report 1/03, discussions were held with 440 contacts. 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 associated with the network will rise to about 1000 persons, who will be contacted once or twice a year. Østlandsforskningen is responsible for the network and conducts contact meetings in Hedmark county.

Our assessments are based primarily on official statistics, but because of the time lag involved and revisions of these statistics, supplementary information from other sources is useful. The regional network provides up-to-date information on the state of the Norwegian economy. Regular talks with local business and community leaders provide information that can supplement available official statistics. Moreover, we obtain supplementary information about areas not covered by official statistical sources. We also learn which issues are of particular concern to enterprises.

Region Inland seems to have felt the impact of the downturn to a lesser extent than other parts of the country. Developments in domestic manufacturing are approximately in step with domestic consumption. The construction industry is showing a positive trend in the south-eastern region, primarily due to public building projects, while western Oppland is experiencing weaker activity. On the whole, enterprises providing services to the household sector are faring better than those oriented towards the business sector, primarily due to weak developments for customers in the construction industry, corporate customers that are in competition with foreign companies or dependent on customers in these categories. Employment is stable, but many enterprises, particularly in the public sector and the construction industry want to downsize in response to higher costs, lower budgets or as part of general, planned workforce cutbacks. Developments in Raufoss may have a considerable impact on the local community. Pay increases are expected to be considerably lower in 2003 than in 2002. Wage growth is highest in the public sector.

There are wide regional variations in unemployment. At end-April, 3.2 per cent of the labour force in Hedmark and 2.9 per cent in Oppland had registered as unemployed. This is well below the national average of 3.9 per cent.

The increase in unemployment on a national basis in 2002 primarily occurred in the service industries. In January, manufacturing took over the lead as the industry with the highest increase in unemployment. Manufacturing unemployment is now 3700 higher than a year ago.

Agriculture and forestry account for a larger share of employment in Hedmark than in other counties. Because of the large tracts of forest in this county, forestry is a particularly important sector. The wood and wood products industry accounts for about a fourth of manufacturing employment. As in the rest of the country, the public sector and parts of the private service sector are important for employment in Hedmark. Business and financial services account for a smaller share than the national average.

In spite of interest rate cuts and a stimulatory government budget, overall economic policy has been tight as a result of the strong krone.

The depreciation of the krone exchange rate since January and the reduction in the interest rate have, however, contributed to an easing of monetary policy. In the Inflation Report, we presented two alternative scenarios for the Norwegian economy. In the baseline scenario, where the interest rate is held constant at 5½ per cent and the krone exchange rate at the average for the past month, mainland GDP is projected to increase by 1¼ per cent this year and 2 per cent next year. This is lower than what is considered the long-term growth potential in the economy. In 2005, growth is projected at 2¼ per cent. An alternative scenario, which incorporates monetary policy easing in line with market expectations - as they were then, points to higher growth over time.

The rise in prices for goods and services produced in Norway is being influenced by markedly higher wage growth in Norway relative to trading partners. Wage growth moved up further last year, even in industries where profitability had weakened considerably. A more moderate rise since last summer is related in part to lower air transport prices (increased competition between airlines) and a slower rise in house rents. The rise in prices for imported consumer goods has been pushed down by the strong krone exchange rate. The shift in clothing imports from high-cost countries to Asia and Eastern Europe has also contributed.

In the near term, the appreciation of the krone over the past two years will be reflected in the underlying rise in prices. Subsequent developments will partly depend on developments in the global economy, the effects on the business sector of the high cost level, the krone exchange rate and how changes in the exchange rate feed through to consumer prices in Norway.

In the baseline scenario presented in the Inflation Report, where the interest rate is held constant at 5½ per cent and the krone exchange rate at the average for the past month, inflation is projected to remain below 2½ per cent over the forecast horizon. The alternative scenario, incorporating monetary policy easing in line with market expectations, points to inflation above the target at the two-year horizon.

Norges Bank has reduced the sight deposit rate from 7 to 5 per cent since 11 December last year. A lower interest rate differential has been followed by a weaker krone exchange rate. The lower interest rate and weaker krone have both contributed to a more expansionary monetary policy.

The last interest rate reduction reflected expectations of low inflation as a result of the strong krone and low international price inflation. Global economic developments are still sluggish. Low interest rates and tax cuts are being used in a number of countries to sustain activity. It is uncertain when economic growth will become self-driven. Since the Inflation Report was presented on 5 March, key rates have been reduced in the euro area, Sweden, Denmark and New Zealand. Growth is also slow in the Norwegian economy. Developments in parts of the business sector are marked by a high cost level, low profitability and the global downturn. Investment may be lower than projected in the Inflation Report.

On the whole, developments over the past few weeks point to a more moderate rise in prices in the period ahead. Norges Bank reduced its sight deposit rate by ½ percentage point to 5 per cent on 30 April. According to Norges Bank's overall assessment, with an interest rate of 5.0 per cent, the probability that inflation two years ahead will be lower than 2½ per cent is greater than the probability that it will be higher.

Footnotes

[1] 72.9 per cent in March - against a 30-year average of 80.2 per cent 1972-2003.

[2]Private defined-benefit pension schemes are estimated at approximately 3 per cent of GDP. Estimate by the Pension Benefit Guaranty Corporation, referred to in The Economist, May 2003. 10