Outlook for Norwegian business and industry and the role of Norges Bank

Address by Governor Svein Gjedrem to Kongsvinger Business Forum 2003, 6 March 2003

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 5 March and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

As a result of the strong krone, prices for imported goods have fallen. This has led to low and stable inflation in spite of sharp wage growth. Even though the krone has depreciated recently, it would appear that inflation will also remain low in the years ahead.

The krone exchange rate fluctuates. This is not surprising: other countries' currencies also fluctuate. The Swedish krona, pound sterling and the New Zealand dollar have in periods exhibited wide swings.

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.

Capital flows freely and flows can change rapidly. This can spill over to exchange rates and interest rates as well as output and employment.

Currency swings are driven by cross-border capital movements. Capital flows were heavily influenced by investor focus on stock market returns until the downturn began. In the US, equity prices almost trebled between 1995 and 2000. Stock markets in other countries followed suit. The decline was amplified after the downturn in the global economy deepened as a result of terror and fears of war. Investors sought to avert the risk in the stock market. Capital inflows into the stock market resulted in a strong dollar. However, expectations concerning corporate earnings were higher than later proved to be warranted. When expectations were lowered, equity prices fell. The demand for bonds increased, resulting in low long- term interest rates.

Major economies such as the US, Germany and France are struggling with stagnation and fears of recession. Substantial tax relief and low interest rates are holding up activity in the US. The Japanese economy has been in a deflationary recession for a long period.

In recent years, the krone exchange rate has shadowed the difference between Norwegian and foreign short-term rates. This is why the krone has appreciated to its current strong rate. In addition, high oil prices have had an influence. The effect of the interest rate differential on the krone has been intensified by conditions in capital markets. Investors have been favouring carry trades. Risk premiums in major currency markets have been low, which seems to indicate that investors have been less prone to speculate in exchange rate fluctuations.

As equity prices fell, investors started seeking alternative vehicles. This made the krone market more attractive. The krone appreciated at the same time that foreign stock markets and domestic equity prices fell. Bonds and other interest-bearing securities have been of particular interest.

There is uncertainty as to developments in many of the factors that will influence inflation in the period ahead. This includes the krone exchange rate. The relationships in the foreign exchange market are unstable.

As a result of the strong krone and a high wage level, competitiveness in business and industry is close to 15 per cent weaker than the average for the past 30 years. Historically, following such substantial deviations, competitiveness has always returned to the average fairly rapidly. In the long term, the krone cannot remain as strong as it has been. This would require a substantial improvement in our capacity to generate income.

From January 1996 to end-January 2003, wages in Norwegian manufacturing increased by 15 per cent more than wages among trading partners. In the years around the millennium, the underlying deterioration in competitiveness was veiled by the depreciation of the krone. In May 2000, the krone hit its lowest level in six years. The krone has since appreciated, and the effect of high wage growth has gradually come into evidence in company accounts.

In the ten years that have passed since the banking and currency crisis in 1992, the economy featured a long period of balanced growth. However, towards the end of the upturn the economy was facing labour shortages, accelerating wage growth and a sharp increase in household consumption and debt. Interest rates in Norway had to be kept at a high level.

The turnaround abroad took place two years ago, but the Norwegian economy continued to show a high level of activity. This led to a widening of the interest rate differential against other countries. The main explanation for the wide interest rate differential is not that interest rates are high in Norway, but that interest rates are at a historic low abroad. The interest rate differential has now narrowed.

A further jump in wages in 2002 amplified the imbalances in the economy and fuelled the rise in prices for goods and services produced in Norway. This is why monetary policy has been tight.

The real interest rate, i.e. the interest rate adjusted for inflation, rose in 2000 and was thereafter somewhat higher than the average for the past 30 years. With the reduction in the key rate this winter, the real interest rate is no longer particularly high.

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

The US has been the driving force in the world economy. The US economy has historically been very resilient. Growth has tended to pick up rapidly after short periods of contraction, which is very likely to happen this time as well. A positive aspect is that confidence in the financial system has not been impaired. There is some evidence of a recovery in investment.

However, we cannot exclude the possibility of a fairly long period of stagnation in the global economy. Low interest rates in the US and Europe are a reflection of this risk. The level of investment in the US was high through the upturn, and this may have created overcapacity in the business sector. The fall in equity prices is having a negative effect on household wealth. In addition, US household saving is low and low interest rates have induced households to accumulate debt. The fall in the value of the dollar may make a contribution, but growth in the business sector is still not self-driven and the depreciation of the dollar is reducing other countries' exports. The impetus generated by the US economy may be weak for several years ahead.

Nor is the rest of the world showing clear signs of an imminent recovery. If the world economy continues to stagnate over a longer period, the effects will also spill over to the Norwegian economy. The decline in traditional exports will then persist. Sooner or later, the oil market will also feel the effects of the downturn and oil prices will decline.

A precondition for countering a possible downturn by means of monetary policy easing is slower growth in labour costs. Monetary policy cannot prevent an increase in unemployment that is caused by a significantly higher rate of growth in labour costs in Norway compared with other countries.

Global stagnation has changed the domestic inflation outlook in recent months. World stock markets have continued to decline. It does not appear that interest rates in the US and Europe will increase in the near future. They may even be reduced further before the recovery starts. In Norway, the interest rate has also been reduced. At the same time, fiscal policy is stimulating activity, partly through tax reductions and growth in government allocations. In addition, state finances weaken when the economy shows little growth and unemployment rises.

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. 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 responsibility for implementing monetary policy has been delegated to the central bank. This is also the case in comparable countries. Norges Bank sets the interest rate so that future inflation will be equal to the inflation target of 2½ per cent.

High demand for goods and services and labour shortages normally point to higher inflation in the future. 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 inflation target is a vehicle for, not an obstacle to, monetary policy's contribution to stabilising output and employment. This intention is also expressed in the Regulation on Monetary Policy.

The inflation target of 2½ per cent is broadly in line with the inflation targets of our trading partners. It is also an anchor for developments in the krone exchange rate. The krone fluctuates. We have open trade with other countries and free capital movements. We do not have the instruments to fine-tune the krone exchange rate. As long as inflation remains low and stable, any substantial deviations in the krone exchange rate over time will have a considerable impact on activity in business and industry. The best contribution monetary policy can make to stability in the krone exchange rate is to aim at low and stable inflation.

High labour costs, a strong krone and global stagnation are leaving a mark on Norway's internationally exposed sector. Many enterprises will not be able to sustain activity given current market conditions and cost levels. Labour costs are also squeezing margins in some private service industries. More enterprises are competing on international markets. Moreover, even if allocations are growing, public entities have limited capacity for increasing employment because wage expenses have risen so sharply.

Unemployment has edged up recently. The current unemployment rate of 4 per cent is more or less on a par with unemployment in 1997. It is also 2 percentage points lower than the average number of unemployed and persons participating in labour market programmes in the 1990s.

The inflation targets adopted by Norway and our trading partners imply that total wage growth of about 4½ per cent is consistent with little or no change in business sector competitiveness.

Growth in real wages is now markedly higher than the underlying growth in productivity. This is why unemployment is rising. Businesses must adjust their workforces to sustain profitability. This leads to a fall in employment, but also to continued operations in Norway. The alternative is that companies are not able to adjust their workforces quickly enough. If higher costs cannot be passed on to customers, earnings will fall and the wage share rises. This may lead to closures or relocation of production.

The increase in real wages results in high growth in household income, consumption and housing investment. The propensity to borrow increases and house prices rise sharply. On the other hand, the business sector faces pressures on profitability, a high cost level and declining investment. Commercial property prices fall. At the same time, corporate restructuring brings growth in employment to a halt. When costs reach a high level, employment starts to fall. The period of expansion has then come to an end. The cost level must be adjusted to restore balance in the labour market.

Last year's wage settlements resulted in wide differences in pay increases across different groups. This may give rise to renewed tension between occupational groups and new wage spirals. Because substantial pay increases negotiated in 2002 will take effect in 2003, wage growth will also be high this year even without any new generous pay increases. It may take time and be very costly for business and public entities to resolve the problems caused by last year's wage settlements. We will be well into 2004 before we can assess how high the unemployment rate will be in this business cycle.

During the autumn and winter, developments in the global economy have proved to be weaker than expected by Norges Bank and many other observers. Many central banks have responded by reducing interest rates further. Interest rates in the US and Europe are unusually low.

Global growth is still projected to pick up gradually towards a more normal level, but the recovery is expected to take place at a later stage.

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

Employment is projected to fall this year and remain unchanged in 2004. Unemployment has increased in recent months. Manufacturing has become more pessimistic. Even though the krone has recently depreciated, profitability is still weak. The full effects of the high cost level have still not come into evidence in the business sector. Since some companies have already taken decisions concerning closures and relocation, we must expect private sector employment to continue to climb. High wage growth has also reduced demand for labour in the public sector.

Registered unemployment is projected to increase from 3¼ per cent in 2002 to 4 per cent in 2003 and up to 4¼ per cent in 2004. Unemployment is then projected to stabilise at this level in 2005.

There are wide regional variations in unemployment. At end-January, 3.3 per cent of the labour force in Hedmark was registered as unemployed. Unemployment figures indicate that unemployment in the Glåmdal region - Sør-Odal, Nord-Odal, Kongsvinger, Eidskog, Grue, Åsnes and Våler - is on a par with the average for the county as a whole, which is well below the national average of 3.9 per cent.

The increase in unemployment in Norway in 2002 primarily occurred in service industries. In January, manufacturing took over as the industry recording the highest increase in unemployment. There are now 3700 more unemployed in manufacturing than one year earlier.

Agriculture and forestry account for a higher share of employment in Hedmark county than in the rest of the country. Because of the large tracts of forest in this area, forestry is a particularly important sector. This is also the case for the Glåmdal region.

Measured by number of employees, manufacturing is more concentrated in the seven municipalities of the Glåmdal region than in the rest of Hedmark county and Norway as a whole. 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. The number employed in commercial and financial services is lower than the national average.

A relatively small share of manufacturing activity in Hedmark is export-oriented. However, many private sector enterprises are probably feeling the pressure of competition from Sweden.

Statistic Norway's business tendency survey shows that manufacturing leaders' expectations regarding future developments are negative. Companies report a decline in output, employment and order backlogs for both export and domestic markets.

New orders in manufacturing fell sharply in the third quarter last year, then rose again somewhat in the fourth quarter. However, the increase in new orders is not large enough to maintain the order backlog.

The sharp rise in electricity prices may lead to lower growth in consumption this year. Many enterprises will also be facing higher costs. On the other hand, high electricity prices generate revenues for central and local government.

Higher electricity prices will result in a sharp increase in the consumer price index this winter. Underlying inflation will also be affected. For example, this can be the result of higher rents and higher costs in some business sectors. However, these effects can to a large extent be disregarded. Assuming that weather conditions remain fairly normal over the next year, the rise in prices at the same time next year will be that much lower. This means that electricity prices will then make a comparable negative contribution to overall inflation.

Growth in the Norwegian economy was sustained by a strong increase in household consumption through 2002. In line with expectations, the sharp rise in real wages fuelled particularly high consumption growth last autumn.

There are now signs that the strong growth in consumption may be slowing. Household expectations regarding the Norwegian economy are more pessimistic than earlier. Households are also less optimistic about their own financial situation.

In the last few months, house prices have risen at a slower pace than in previous years. Activity in the housing market has been lower and it takes longer to sell a dwelling. Growth in household borrowing remains high, but has eased somewhat recently. Weaker developments in house prices and reduced household optimism may further restrain credit growth in the future.

Developments in the Norwegian economy also appear to be weaker than projected in October. 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 sharp erosion of competitiveness over several years will have a dampening impact on growth in the period ahead.

The interest rate cuts this winter will contribute to stimulating household demand in the period ahead and curb the negative effects of higher electricity prices and increased uncertainty. Private consumption may nevertheless move on a weaker path than previously assumed.

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.

Growth in mainland GDP is projected to be lower than trend growth, at 1¼ per cent in 2003 and 2 per cent in 2004. In 2005, growth is projected at 2¼ per cent. Aggregate output, which has been high for a long time, is projected to return to a level that is more consistent with a long-term output trend.

The underlying rise in prices in the coming year will be marked by the appreciation of the krone over the last two years. Despite high wage growth, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products (CPI- ATE) will most likely range between 1½ and 2 per cent until the summer. Subsequent developments will partly depend on externally generated inflationary impulses, changes in the exchange rate and how these changes feed through to consumer prices in Norway.

In the baseline scenario in the March Inflation Report, where the interest 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 throughout the projection period. In an alternative scenario, which includes an easing of monetary policy in line with market expectations, inflation is likely to be higher than the target at the two-year horizon.

Norges Bank's Executive Board assessed the interest rate at its monetary policy meeting on 5 March. It was decided to reduce the interest rate from 6 per cent to 5.5 per cent. According to Norges Bank's assessment, with an interest rate of 5.5 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.