Monetary policy in an oil economy

Governor Svein Gjedrem. Norwegian United Federation of Trade Unions, Oslo, 21 August 2002

Please note that the text below may differ slightly from the actual presentation.

The global economy is characterised by financial market turbulence, low growth and rising unemployment. Even though the global unrest has had an impact on some sectors of Norwegian business and industry, activity in the Norwegian economy as a whole is still high, with solid growth in demand for goods and services. Aggregate demand is being fuelled by strong growth in household income. There is also a high level of activity in the petroleum sector and oil prices are high. Petroleum investment remains buoyant. The labour market is tight. This is reflected in the relatively high wage increases in Norway. Growth in labour costs has been considerably higher in Norway than among our trading partners for several years. Combined with the global downturn and a strong krone, this is having a severe impact on manufacturing.

Scaling back manufacturing involves a risk. It makes the economy more vulnerable. The growth potential of the economy - the basis for learning, innovation and development - may be impaired when less of the business sector is exposed to intense foreign competition.

High wage growth affects the exposed business sector in two ways. First, it erodes earnings and reduces employment. Second, monetary policy has to be tightened. This leads to an appreciation of the krone, with a further reduction in earnings and employment.

It is overall wage growth - combined for all groups - that influences the outlook for inflation. However, substantial wage increases for some groups can trigger wage spirals. Wages for salaried staff in the business sector have exhibited sharp growth over several years. This year, it appears that wage increases will be especially high in the public sector and in parts of the private service sector.

A year and a half ago, the Government and the Storting adopted new guidelines for economic policy. The guideline for fiscal policy implies annual use of petroleum revenues equivalent to the expected real return on the Government Petroleum Fund. Most of the phasing in of petroleum revenues is likely to take place over the next ten years. With a return on the Petroleum Fund of 4 per cent, annual use of petroleum revenues may approach NOK 60 billion, measured in current prices, in 2010.

At the same time, the Government issued a new operational mandate for monetary policy. Norges Bank shall set the key rate with a view to maintaining low and stable inflation.

The regulation reads as follows:

"Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy."

The first paragraph sets forth the objective. The last paragraph specifies what Norges Bank shall do.

"Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time."

The first sentence in the mandate refers to the value of the krone. Stability in the national value of the krone implies that inflation must be low and stable. This is the best contribution monetary policy can make to economic growth and welfare. It is also a necessary precondition for stability in financial markets and property markets.

The regulation also states that monetary policy shall be aimed at stability in the international value of the krone. The krone exchange rate fluctuates from day to day, from week to week, and from month to month. We have free international trade and free capital movements. We do not have the instruments for fine-tuning the exchange rate. In Norges Bank's submission of 27 March 2001 to the Ministry of Finance on the new guidelines for economic policy, we indicated that when monetary policy is aimed at low and stable inflation, this is the best contribution monetary policy can make to stability in the krone exchange rate over time.

The interest rate affects price inflation through a number of channels, including the krone exchange rate. A stronger krone curbs inflation. If we take steps to counteract an appreciation of the krone when there are pressures in the economy, we reduce the possibility of keeping inflation at bay and there is a greater risk of pronounced fluctuations in the economy. Maintaining stability in the internal value of the krone must take thus precedence. As long as other countries pursue a policy of low and stable inflation, stability in the international value of the krone is dependent on low and stable inflation in Norway.

In the regulation's second paragraph, responsibility for the implementation of monetary policy is delegated to Norges Bank. This implies that Norges Bank sets the interest rate on the basis of our understanding of the regulation - as indicated in the Bank's submission to the Ministry of Finance in March last year. Our interpretation places emphasis on the Government's rationale behind the regulation, on the objective as formulated in the first paragraph and on our knowledge about the relationships between the interest rate, the krone exchange rate, production, employment and inflation.

The operational objective of monetary policy is low and stable inflation. The inflation target is set at 2½ per cent. A monetary stance resulting in high and varying inflation would have led to wider swings in production and employment. It would also have been a recipe for turbulence in the foreign exchange markets. There is therefore a close link between the third paragraph of the regulation - the inflation target - and the first paragraph concerning stabilising economic developments and exchange rate expectations.

Growth in the Norwegian economy is primarily being fuelled by a sharp rise in private consumption and strong growth in household disposable income. Growth in real household income is projected at close to 5 per cent this year, which is a historically high level. Growth in domestic credit remains buoyant. Household borrowing is at a high level. House prices have risen sharply, though unevenly, for several years. Strong demand growth necessitates a tight monetary stance. However, the strong krone exchange rate reduces import prices and thus contributes to keeping down interest rates. It is not the case that concerns for stability in production and employment would imply a relaxation of monetary policy. Had we placed greater emphasis on these concerns, monetary policy would have been tighter and the interest rate higher in order to prevent a borrowing and consumption spree.

The interest rate influences inflation through two channels: through domestic demand for goods and services and the krone exchange rate. When interest rates rise, it is more profitable to save and more costly to borrow. This has a dampening impact on consumption and investment. Lower demand in turn curbs the rise in prices and wages. Higher interest rates also make it more attractive to take krone positions and borrow in foreign currency. As a result, higher interest rates normally lead to an appreciation of the krone. This reduces prices for imported goods. In addition, a strong krone curbs activity, profitability and the ability to pay in the internationally exposed sector, and thereby cost pressures in the Norwegian economy.

The mandate for monetary policy implies that the interest rate must be adapted to the outlook for the Norwegian economy. If it appears that inflation, with an unchanged interest rate, will be higher than 2½ per cent, the key rate will be increased. If it appears that inflation, with an unchanged interest rate, will be lower than 2½ per cent, the key rate will be lowered. Such a monetary policy will normally also contribute to stabilising production and employment.

Monetary policy functions with considerable and variable lags. The current inflation rate does not provide a sufficient basis for determining at which level interest rates should be set now. Our analyses indicate that a substantial share of the effects of a change in interest rates will occur within two years. Two years is thus a reasonable time horizon for attaining the inflation target.

It is nevertheless conceivable that in a situation with a high rate of inflation and sluggish economic developments, Norges Bank may decide to apply a somewhat longer time horizon than two years to reach the target of 2½ per cent. By influencing inflation over time, monetary policy will not in itself inflict unnecessary disturbances on the economy.

Norges Bank has one instrument, which is the interest rate. It has a broad impact. Monetary policy can therefore not be oriented towards stabilising developments only in the internationally exposed sector. This would create considerable imbalances in the Norwegian economy.

The low interest rate policy and devaluations in the 1970s and 1980s are examples of how such a policy can fail. Monetary policy was geared towards preventing a weakening of competitiveness in manufacturing. The krone was devalued on several occasions. But wage growth accelerated to compensate for higher inflation. The result was a wage and price spiral that hit the entire economy.

The last devaluation took place in spring 1986 after yet another expensive wage settlement and a sharp fall in oil prices. Monetary policy was then revised. The fixed exchange rate regime gradually brought inflation in Norway into line with inflation in other countries.

In the late 1980s, however, the Norwegian economy first had to go through an extensive turnaround operation. Confidence in monetary policy and the Norwegian krone had to be restored in order to avoid persistently high inflation. It took a long time, and very high interest rates were required, before confidence in the nominal anchor was regained.

The economy only started moving on a more stable path when wage and income formation was clearly anchored in the objective of monetary policy, which at that time was stability in the krone exchange rate.

This illustrates that there must be general confidence in Norwegian and international foreign exchange and financial markets that domestic inflation will remain low and stable. If this confidence does not exist, a decline in short-term interest rates will lead to higher long rates and a sharp depreciation of the krone. This will in turn result in wider fluctuations in the economy.

Business sector competitiveness has now deteriorated. The krone is strong because wage growth is high and demand is expanding. If wage growth moderates and there is confidence that it will remain low in coming years, the interest rate differential against other countries can be narrowed. Normally this will lead to a depreciation of the krone. The outlook suggests that cumulative wage growth in Norway will be a good 15 per cent higher than in other countries from 1998 to 2003. The krone is now about 7 per cent stronger than the average for the 1990s. The appreciation of the krone is reversible, but the loss of competitiveness and jobs caused by the high level of domestic wage growth is difficult to redress.

Under the so-called "Solidarity Alternative" in the 1990s, a stable exchange rate and the rate of wage growth among our trading partners functioned as an anchor for the social partners. Up to 1997, this anchor remained effective. However, growth in labour costs jumped in 1998 and has since been around 2 percentage points higher than among trading partners, ranging between 5 and 6 per cent each year. This year's wage settlement appears to be following suit and also points to a high rate of wage growth next year. Wage growth is high in relation to earnings in many enterprises. It is demanding to improve efficiency at the pace required to keep up with the rise in labour costs.

In recent years, wage growth among trading partners has not served as an anchor for wage growth in Norway. In the public sector, wages are rising at a considerably faster pace than the level on which the government budget is based. This has an effect on the production of services.

Nominal underlying public expenditure growth will be around 7 per cent between 2001 and 2002. This is markedly higher than private sector mainland GDP growth, which may be estimated at around 4 per cent in nominal terms. The fiscal guideline is being closely adhered to. Real growth in public consumption is estimated at 1½ per cent. In 2003, growth in service production is estimated at only ¾ per cent. This implies only moderate growth in public services even though public expenditure is rising sharply. The explanation is that the cost of producing public services is rising markedly, which reflects the high rate of wage growth. In addition, transfers to households through our social security schemes show considerable growth.

The bulk of the high growth in central government allocations therefore translates into strong growth in household income and consumption. This does tend to be the result when wage and cost pressures are already at such a high level. If the central government were to compensate public sector entities for the high wage increases, the result could easily be a new round up the wage spiral.

In the July *Inflation Report*, our estimates showed that with an unchanged sight deposit rate, which was 6.5 per cent at the time, and a krone exchange rate equal to the average for the second quarter, inflation two years ahead would be higher than 2½ per cent. Moreover, the estimates showed that inflation might be lower than 2½ per cent in the short term. If we had attempted to attain the inflation target in the very short term by lowering the key rate, thereby contributing to a depreciation of the krone and higher inflation, we would have had to raise the key rate about a year from now substantially more aggressively than the recent gradual increase. This would have amplified fluctuations in production and employment.

During the 1990s, we saw that unemployment declined as long as wage growth in Norway was lower than wage growth among trading partners. This came to a halt in 1998 when the social partners rejected further wage moderation. Unemployment stopped falling.

The sharp rise in labour costs in recent years carries with it a potential for higher unemployment. The interest rate is an effective instrument for countering lower demand and growing unemployment when stronger demand does not translate into higher wage growth or unstable financial markets. However, there is little monetary policy can do to prevent an increase in unemployment that is driven by labour costs.

Real wage growth that is higher than productivity growth results in deteriorating corporate profitability. Firms will then hire fewer people and shed labour. This also leads to a heightened conflict between budget limits and service production requirements in the public sector. High wage growth places increased demands on efficiency in the business and public sector. This increases flows out of the labour market into various social security and pension schemes.

Over the last thirty years, manufacturing has been scaled back in waves. Particularly in the years from 1977 to 1984 and 1987 to 1992, the decline was substantial. In the years leading up to the periods of contraction, profitability weakened in the manufacturing sector. It can take time for such a weakening to translate into lower production and employment, but when the turnaround occurs, the downscaling tends to be rapid and substantial. It now appears that a new period of downscaling is under way.

The Norwegian krone has appreciated markedly this year. An important driving force has probably been developments in wage settlements. Operators in the foreign exchange market have reacted as could be expected. High wage growth eventually leads to high interest rates, which makes it attractive to take krone positions and borrow in foreign currency. As a result, the Norwegian krone strengthens.

We are and must be prepared for fluctuations in the krone exchange rate in line with that observed in other countries. There is free trade in goods and services and free capital movements. The krone is floating. This means that economic agents *cannot* assume that the krone will be stable against the euro, against the dollar or against a weighted average of foreign currencies.

The fluctuations in the krone exchange rate have not deviated from the norm for other small currencies. A large share of petroleum revenues is invested in foreign equities and bonds through the Petroleum Fund. Changes in oil prices influence the size of the Fund, but have little effect on the domestic use of petroleum revenues. The Petroleum Fund thus serves as a buffer against fluctuations in oil prices and a shield for the krone exchange rate. We must nevertheless be prepared for exchange rate fluctuations on a scale observed for other minor currencies.

But the krone can move in both directions. It will not appreciate indefinitely. Over the last two years, the appreciation of the krone has been driven by the wide and increased interest rate differential between Norway and other countries. The interest rate differential reflects high wage growth in Norway. In other words, easily comprehensible forces have been behind the changes in the krone exchange rate. But most likely these forces are also reversible. Sustained lower wage growth, more in line with the level abroad, will be accompanied by a narrower interest rate differential.

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. The figures are closely in line with developments in the 1990s when wage growth averaged 4½ per cent and inflation was 2½ per cent. The krone exchange rate was stable.

High interest rates and the strong krone reflect real economic driving forces such as a high level of petroleum revenues, a tight labour market and strong growth in household income, consumption and borrowing. A shift in the wage formation process may have added to the particularly high rate of overall wage growth. If these forces are restrained, there is also hope that the pressures on monetary policy will subside.

A lower level of wage growth would provide a strong impetus to the internationally exposed sector. Lower wage growth would boost earnings and employment. In addition, interest rates could be reduced. Normally, this would lead to a depreciation of the krone so that earnings and employment would improve further. Manufacturing may therefore notice the positive effects of low nominal wage growth to an even further extent than earlier. If wage growth is anchored in the inflation target, and financial market confidence is maintained, monetary policy would also be an effective instrument in the event of a fall in aggregate demand.

Thank you for your attention.