The Norwegian economy and monetary policy

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 22 May and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

Norway's economic policy is based on the guidelines for fiscal and monetary policy. The guideline for fiscal policy states that the use of petroleum revenues over the central government budget shall be equivalent to the expected real return on the Government Petroleum Fund. This means that all the capital in the Petroleum Fund is being utilised since the return is being used in its entirety. Monetary policy is oriented towards low and stable inflation. Historically, periods of high inflation have always been followed by a downturn. Low and stable inflation fosters stability in the economy.

Establishing guidelines for economic policy is not new. Both fiscal and monetary policy have been subject to a rules-based framework throughout the post-war period, with the exception of the last half of the 1970s and the first half of the 1980s.

The phasing in of petroleum revenues in the central government budget shall be equivalent to the expected return on the Petroleum Fund. Most of the phasing in of petroleum revenues will take place over the next ten years. With a four per cent return on the Petroleum Fund, the use of petroleum revenues will rise to almost five per cent of mainland GDP in 2010.

Growth in public spending from last year to this year is estimated at seven per cent. This is considerably stronger than the growth in value-added in the private sector of the mainland economy, which is estimated at around four per cent. The guideline for fiscal policy has been followed closely. Real growth in public consumption is estimated at 1½ per cent. In other words, there will only be moderate growth in the production of public services even if the central government increases its allocations.

This is because the cost of producing public services is rising sharply, reflecting high wage growth in the public sector. There have also been substantial increases in transfers to the household sector in connection with our social security system. As a result, most of the strong growth in central government allocations translates into a sharp rise in household consumption, while growth in public service production remains moderate. This is only to be expected when there is strong growth in public sector allocations in an economy with no available resources.

Monetary policy is oriented towards low and stable inflation. The inflation target is set at 2½ per cent. In general, effects on consumer prices resulting from changes in direct and indirect taxes or extraordinary temporary disturbances shall not be taken into account.

The inflation target provides an anchor for expectations concerning future inflation and interest rates. Monetary policy affects the economy with a lag. The current level of inflation does not provide an adequate basis for determining the level at which interest rates should be set today. 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.

Economic agents can act on the assumption that the inflation rate will be 2½ per cent. 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. There is symmetry here. 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.

The interest rate is the most important monetary policy instrument. It affects price inflation through two channels: demand for domestic goods and services and the krone exchange rate.

Labour costs are important. A tight labour market leads to high wage growth. High levels of private and public consumption, investment and exports will sustain the demand for labour. When the supply of labour is limited, the competition for labour pushes up wages. A tight monetary policy stance with a high real interest rate will curb domestic demand.

In many countries, low and stable consumer price inflation is the goal of monetary policy. We can therefore expect a slow rise in prices for imported goods. However, the rise in import prices varies in pace with global economic developments.

The krone exchange rate also plays an important role in determining import prices. A strong krone will curb prices for imported goods, while a weak krone will result in higher prices. When there is a rise in the interest rate in Norway and a widening differential between domestic and foreign interest rates, investments in NOK will increase, and the krone exchange rate will rise.

Price inflation may vary considerably from month to month. This variation may be due to random or temporary conditions, such as fluctuations in electricity prices or petrol prices, or the effects of changes in indirect taxes. When we assess the interest rate, we disregard these effects. An indicator for adjusted price inflation - CPI-ATE - is the measure we use to examine monetary policy performance.

Steep increases in public sector allocations, growth in private consumption and strong growth in labour costs fuel high price inflation for goods and services produced in Norway.

Inflation remains subdued because prices for imported goods have dropped. A stronger krone exchange rate, increased trade with developing countries (especially China and eastern Europe), a reduction in tariffs and the global downturn have kept import prices low. If the krone exchange rate remains at today's level, imported price inflation will remain subdued.

To maintain a balance in the Norwegian economy, the phasing in of petroleum revenues must be countered by a monetary policy stance that is tighter than it would otherwise have been. This may be accomplished through a higher interest rate than would otherwise be the case, an appreciation of the krone, or both.

Norway's fiscal policy will stimulate demand in the public and sheltered sectors. Consequently, internationally exposed industries may have difficulties recruiting labour and may face higher labour costs. Competition for labour may result in deterioration in competitiveness.

The guidelines for economic policy may affect the krone exchange rate in two ways.

On the one hand, increased use of petroleum revenues may lead to a deterioration of the business sector's competitiveness. With low and stable inflation, this may at times be reflected in a strong krone.

On the other hand, our inflation target is slightly higher than the objective for price inflation among our trading partners. In the long run, this will be offset by a corresponding depreciation of the krone.[1]

The size of the exposed sector will be affected by the extent to which petroleum revenues are absorbed into the Norwegian economy. In the long run, monetary policy cannot influence overall employment or its distribution across industries.

Wage growth has remained at between five and seven per cent every year since 1998. It appears that this year's wage settlement will result in a similar outcome. Strong wage growth is the result of a tight labour market. In other countries, the situation is different, with sluggish economic developments and declining inflation. As a result, the interest rate is higher in Norway than in other countries.

Excessive wage growth affects the exposed business sector in two ways: earnings and employment are reduced and the interest rate is increased. An increase in the interest rate normally results in an appreciation of the krone, with a further reduction in earnings and employment. The manufacturing sector will therefore feel the effects of excessive wage growth to an even greater extent than earlier.

The phasing in of petroleum revenues increases the demand for labour from the public sector and from enterprises selling goods and services to households. With little slack in the economy, employment in the internationally exposed sector must decline.

As competitiveness has deteriorated, manufacturing employment has been scaled back in waves. Competitiveness deteriorated by around 10 per cent from 1994 to 2001. If wages in Norway relative to other countries develop along the same lines as last year and the krone exchange rate remains at the present level to the end of the year, competitiveness will deteriorate further by around seven per cent.

In the long run, wages must be compatible with the value added that is generated by workers, i.e. labour productivity. Over time, the increase in real wages is therefore determined by developments in labour productivity.

In mainland Norway, annual productivity growth has averaged 1½ - 2 per cent over the last twenty years. If this continues to be the case, an average increase in labour costs of around 4 - 4½ per cent in the long term may be consistent with the inflation target. When manufacturing and other industries exposed to competition are scaled back to the extent that there is room for a larger service sector, competitiveness will once again stabilise.

However, the situation for Norwegian enterprises will not necessarily be negative. Some enterprises could be at the forefront of technological developments and increase efficiency at a faster pace than the relatively high increase in costs in Norway. Many enterprises are moving large portions of their production abroad. Norwegian manufacturing companies could still be profitable even if the manufacturing industry no longer plays such an important role in the Norwegian economy.

However, 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.

I would now like to comment on the financial position of Norwegian enterprises and households.

The Norwegian mainland economy has grown at a relatively slow pace in recent years, reflecting a limited supply of new resources. The downturn in the global economy has also had a negative impact.

Total credit has declined since 2000, but remains at a high level. However, there are considerable differences between households and enterprises. Growth in corporate debt has slowed in this period due to lower investment.

Household debt has risen at a very high rate. There has been strong growth in household income for several years and expectations with regard to both the nation's economy and personal finances rose sharply in the first quarter of this year. The housing market is still under pressure.

The saving ratio is high, but investments in financial assets have declined as a result of increases in housing investment. A high saving ratio will in principle serve as a buffer. In a situation with declining income or increasing interest expenses, households can choose to reduce saving so as to maintain consumption.

Since 1999, the rise in household debt has been higher than income growth, thus leading to a sharp increase in debt. Nevertheless, the debt burden is on the whole lower than at the end of the 1980s. Higher financial wealth and higher house prices ensure that the financial position of households as a whole is relatively sound.

However, there are considerable differences between household groups. The distribution of net wealth is very uneven. The household group with the highest incomes has increased its share of financial assets over time. In 1999, households in Group 10, that is the ten per cent of households with the highest incomes (more than NOK 490 000 after tax), held assets equivalent to 150 per cent of their debt. For the other groups, financial assets in relation to debt fell throughout the 1990s. In other words, for most households the financial situation has not improved over the last 10-15 years.

The total debt burden is lower today than it was at the end of the 1980s. This is mainly because the highest income group has a lower debt burden. Most households have a higher debt burden today than they did in the 1980s.

At the end of the 1980s, households with the highest incomes had very high debt, while households with lower incomes had low debt. This wide spread was a result of the tax system (full tax deductions for the interest on debt). The real after-tax interest rate was lower the higher income was (high marginal tax). The tax reforms at the end of the 1980s and in 1992 evened out the differences in tax deductibility. After 1990, there was a sharp decline in the total debt burden.

Given that the total debt burden from 1999 to 2001 was equally distributed among the various income groups, the debt burden for households in groups 7-9 is about the same today as it was at its highest at the end of the 1980s. The debt burden for the lowest income groups (1-6) is over 30 per cent higher today than it was at the end of the 1980s.

These estimates indicate that debt will remain high in the mainland Norway business sector in the years ahead. Debt growth is nonetheless expected to slow, approaching the level of growth in nominal GDP, in other words, somewhat lower than it has been over the last ten years.

In the chart, an alternative scenario is also illustrated, showing the effect on corporate debt of a debt growth of 12 per cent and a 2 percentage point higher interest rate. This would lead to appreciably higher debt in the mainland enterprise sector than was the case at the end of the 1980s.

The Norwegian economy displays a number of strong features. Government finances are solid and foreign trade is performing well. Household finances are generally sound, while the picture is somewhat more mixed for enterprises.

At the same time, this year's wage settlement shows that there are strong tensions in some areas. A major restructuring of the labour market will be necessary and changes will have to be made in the industry structure in Norway in the time ahead.

Footnotes

1. Akram, Q.F. (2000): "PPP despite real shocks: An empirical analysis of the Norwegian real exchange rate". *Working paper 2000/7,* Norges Bank, Oslo, Norway.
2. Gjedrem, Svein (2000): "Economic perspectives" (annual address). *Economic Bulletin 1/2000*, Norges Bank, Oslo, Norway