Monetary policy and the operating environment for our goods-producing industries

Central Bank Governor Svein Gjedrem, Address at a conference hosted by the Federation of Norwegian Agricultural Cooperatives, Trondheim, 11 January 2002

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Norway's economic policy is based on new guidelines for fiscal and monetary policy. The new guidelines were published by the Government on 29 March 2001 in connection with the presentation of the Government's Long-Term Programme. The inflation target for monetary policy became effective immediately. The guidelines for fiscal policy were discussed in the Storting in June and were approved by a majority. The guidelines for fiscal policy imply that the budget deficit shall over time be equivalent to the expected real return on the Government Petroleum Fund.

Monetary policy is oriented towards low and stable inflation. The inflation target is set at 2½ per cent. Low and stable inflation fosters stability and growth in the economy. Historically, periods with high inflation have been followed by a decline in economic activity. It is advantageous that monetary policy is anchored in an objective of low and stable inflation.

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 occurs within two years. Two years is thus a reasonable time horizon for achieving the inflation target of 2½ per cent. If evidence suggests 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 just as important to avoid an inflation rate that is too low, as it is to avoid an inflation rate that is too high.

Norges Bank presented its last *Inflation Report* on 31 October. We expected price inflation to be about 2½ per cent in two years, if growth in the global economy picks up as assumed. Meanwhile, price inflation may be somewhat lower due to the downturn abroad and the decline in prices for imported goods. There is a risk of a deeper and more prolonged downturn in the global economy than we have assumed. This would lead to weaker economic developments and lower-than-estimated price inflation, also in Norway. In addition, the oil market is unstable. There was a tendency towards lower oil prices, but now the oil price has increased to around USD 20 per barrel. Unemployment has edged up.

Based on developments the last few months and analyses in the *Inflation Report*, Norges Bank reduced the deposit rate and the overnight lending rate by 0.5 percentage point on 12 December. We also stated that according to Norges Bank's assessment, with an unchanged interest rate ahead, the probability that inflation two years ahead will be lower than 2½ per

cent is greater than the probability that it will be higher. Norges Bank's key interest rate, the sight deposit rate, is now 6.5 per cent.

At present, the labour market is relatively tight, which is reflected in high nominal wage growth. In other countries, the situation is different, with sluggish economic development and declining inflation. As a result, interest rates are higher in Norway.

The krone exchange rate measured against our most important trading partners has appreciated by 7 per cent since the spring of 2000, when it was very weak. This may be viewed against a fairly high and widening interest rate differential. The krone exchange rate is about 2.5 per cent weaker than in 1990 and at the same level as in the mid-1990s.

Uncertainty surrounding international developments has been unusually high. The terrorist attacks in the US on 11 September may have influenced behaviour and response patterns in such a way that historical experience may no longer be a reliable guide. There has been a recession in the US, Japan and other Asian countries. The decline in the US has spread to the European economies. Channels other than trade have probably had a considerable impact. Capital markets are global, and enterprises with operations in many countries also cut their investments and operating expenses in Europe and Asia when revenues decline in the US. Industrial output has declined markedly in all major regions in the world economy. Norway's manufacturing output has declined somewhat, but less than in the US, Europe and Sweden. On the other hand, Norway did not experience the upswing in the latter part of the 1990s and the beginning of 2000.

The international slowdown is reflected in the prices for the goods we import. We expect a temporary decline in prices for imported consumer goods. This is due to lower commodity and producer prices in the international market, a slower rise in international consumer prices and an appreciation of the krone. As these effects wane, and if global economic growth picks up in line with expectations, import price inflation may reach a more normal level. An expansionary fiscal policy, growth in private consumption and continued high growth in labour costs contribute to a sharp rise in prices for domestically produced goods and services.

According to the Government's estimate, the new guidelines for fiscal policy increase the use of petroleum revenues in the central government budget by an average of barely ½ per cent of mainland GDP each year from 2002 to 2010. The limits for the central government budget were discussed and clarified in a debate in the Storting on 27-28 November. The use of petroleum revenues will be increased by NOK 6 billion or 0.6 per cent of GDP from 2001, which is in line with the guidelines. The Storting has approved a sharp reduction in taxes, equivalent to NOK 12 billion at accrued values. By comparison, the tax cuts in connection with the tax reform in 1992 amounted to about NOK 4 billion (2001 prices).

The new guidelines will stimulate activity in Norway and contribute to sustaining demand for labour in the years ahead. With an annual boost to demand of about ½ per cent of GDP, the use of resources in the service industries will increase more quickly than otherwise. There is a risk that the competition for economic resources may lead to continued higher growth in the business sector's labour costs than among our trading partners. Such a deterioration in competitiveness cannot be countered by the krone exchange rate without fuelling inflation.

Over time, the size of the exposed sector will be affected by the portion of petroleum revenues that is injected into the Norwegian economy but will be independent of monetary policy. Any appreciation of the krone may, nevertheless, affect the speed at which changes occur in the business sector.

To ensure stability and low inflation, the phasing in of petroleum revenues in the Norwegian economy must be countered by a monetary policy stance that is tighter than otherwise. This may be accomplished by a higher interest rate than would otherwise be the case, by an appreciation of the krone, or both. Such a combination of fiscal and monetary policy is not advantageous to Norway's goods-producing industries, which must make significant adjustments when petroleum revenues are used to finance increased welfare for Norwegian households.

When oil made its entry into the Norwegian economy in the 1970s, some of the future revenues were used in advance. The public sector expanded sharply and the internationally exposed sector was scaled back. Historically, closures in the business sector do not occur immediately after sharp wage growth and a deterioration in competitiveness. However, when competitiveness has been deteriorating for a long period and prospects for the future are poor, the downturn has a tendency to come swiftly once it comes. Historically, the exposed sector has been scaled back in waves. In the period from 1977 to 1984 and from 1987 to 1992 in particular, manufacturing industry contracted sharply. Both periods were preceded by a considerable deterioration in cost competitiveness in manufacturing.

On the basis of recent years' deterioration in competitiveness, there is a risk of a new period of decline in manufacturing industry. In Norwegian manufacturing as a whole, labour costs over the past five years have risen about 10 percentage points more than among our trading partners.

The food and beverage industry accounts for about 1/6 of the total number of man-years in manufacturing. The food industry exports roughly 1/4 of its production, primarily processed fish. There is little export of other food. Imports account for roughly 10 per cent of the total food supply in Norway. The food industry and agriculture are largely sheltered. Relatively few of these industries compete in the international market and experience relatively little competition in the domestic market.

Throughout the 1990s, labour costs as a percentage of value added have risen sharply in the food industry. Over time, a certain balance must exist between labour costs and the portion of income that is used to service capital, and this also applies to the agricultural cooperatives. Both wage growth and productivity growth will have an impact on profitability trends. At the same time, profitability depends on developments in prices for the goods produced by the industry.

In 1994, nearly NOK 1 billion was allocated to restructuring the agricultural-based food industry. The measures were initiated on the grounds that the industry would be facing challenges as a result of a change in parameters, among other things the EEA agreement, the new GATT agreement, an expected increase in cross-border trade and increased concentration in the grocery trade. In formulating the proposed support measures, the Ministry of Trade and Industry assumed that the restructuring program would contribute to

a profitable and internationally competitive industry. Emphasis was placed on measures that would contribute to rapidly improving efficiency in production operations.

The sharp rise in labour costs the last five years does not appear to have been matched by productivity gains. According to the national accounts, productivity growth in the food industry has been weak the last 20 years. In fact, productivity has declined by an average of 1 per cent annually. This is considerably weaker than for Norwegian manufacturing as a whole. According to Statistics Norway, sluggish productivity growth in the food industry and in the graphics and publishing industry was one of the main reasons why productivity growth in Norwegian manufacturing was lower than in Swedish manufacturing in the 1990s. It should be emphasised that these figures are uncertain - productivity figures in the national accounts are highly uncertain and difficult to interpret - but we can safely say that we do not find evidence to suggest that the food industry has significantly increased efficiency.

One source that may be used to analyse developments in the food industry is Norges Bank's database Sebra which contains figures for all limited companies that have filed valid accounts to the Brønnøysund Register. The agricultural cooperatives are not covered by these figures. The figures, which are from 1988 to 2000, show that profitability in the food industry is clearly lower now than in the first half of the 1990s. Profitability measured by the return on total assets has been particularly low during the last three years, despite a slight improvement in 1999 and 2000. The figures show that margins have been squeezed in the industry for several years.

In general, it should be easier for an industry that is largely sheltered to pass on cost increases to prices than it is for industries that are exposed to direct competition from abroad. Increased focus on food prices and strict regulations may have prevented this. Increased concentration in retail trade has probably also altered the balance between producer and retailer during the last ten years.

Competition from abroad is becoming more intense. Border trade with Sweden has increased substantially the last few years. Through Sweden's EU membership, the Norwegian food industry is increasingly exposed to competition, not only from Sweden but also from Denmark and other EU countries. Norwegian producers of agricultural products and food cannot ignore this.

A substantial depreciation of the Swedish krona during the last year and a half has increased the price differential between Sweden and Norway. The Swedish krona has depreciated by around 15 per cent against the Norwegian krone since the spring of 2000. All else being equal, this means that Swedish goods are 15 per cent less expensive measured in NOK.

A survey conducted by Statistics Norway in January 2001 showed that the price level of meat products in Sweden was on average about half that in Norway, measured in the same currency. The price differential on dairy products is somewhat less, but still considerable. An obvious reason for these price differences is probably different wage levels in Sweden and Norway. The average monthly pay of a butcher or baker is considerably higher in Norway than in Sweden. For companies, however, it is the total labour costs that are significant. If we take into account that employers' social security contributions in Sweden are more than twice as high as in Norway, the difference in labour costs is less than what is reflected in the

butcher's pay in the two countries. If we also take into account that the business sector in Sweden must pay pension contributions amounting to 7 per cent of wages, the difference in labour costs in Sweden and Norway is even a little less. Nevertheless, labour costs in Sweden are as much as 25 per cent lower than in Norway.

Therefore, the difference in prices for meat and meat products in Sweden and Norway cannot solely be explained by the higher wage level in Norway compared with Sweden.

Another explanation for the price differences is probably the price of raw materials. In Norway, we have chosen to shelter the food industry by means of extensive import protection for food. At the same time, it is natural to call attention to the tight constraints on this industry in the form of agricultural regulations. Clearly, the potential for rationalising operations in an industry where the primary producers are small and geographically spread is limited.

The agricultural industry faces substantial challenges. You encounter market power at the retail stage. Competition from abroad will be considerable, despite trade protection. The phasing in of oil revenues in the Norwegian economy will strengthen many service industries and weaken the position of industries that are more exposed to international competition. We anticipate significant structural changes and improved efficiency in the industry in response to these challenges.