Monetary policy in an uncertain world

Deputy Central Bank Governor Jarle Bergo. Address at a meeting of Sparebank 1 Nord-Norge, Sommarøy, 23 November 2001

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

Summary

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 31 October.

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. A majority were in favour of using 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. In general, direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Low and stable inflation is the best contribution monetary policy can make to growth, prosperity and income distribution. In the long term, monetary policy has little effect on employment and output. Low and stable inflation can provide fertile ground for stability and growth. It reduces the possibility of unsound investments and bubbles in the financial and property markets. Nominal stability will also reduce the risk of sudden changes and shocks that may lead to cyclical turnarounds.

In the last hundred years, we have had three extended inflationary periods - during World War I, World War II and after the oil price shocks in the 1970s and 1980s, which triggered spiralling wage and price inflation. None of these periods will be remembered as being particularly fruitful. The best contribution monetary policy can make to employment, growth and welfare is low and stable inflation.

Historically, economic growth has been strong in periods of relatively low inflation and weak in periods of especially high inflation. Hence, during the last 20 years, real wage growth, which over time reflects productivity trends, has been strongest when inflation was low. In the 1980s, nominal wage growth was robust without a basis for this in the real economy. The result was inflation and subdued real wage growth. In the 1990s, there was a basis for high real wage growth. Moderate nominal pay increases coincided with strong real wage growth because inflation was low.

The interest rate affects inflation through several channels. An increase in the interest rate will normally contribute to reducing inflation by curbing demand for goods and services and by strengthening the krone against other currencies. A lower interest rate has the opposite effect. The effects will depend on the situation prevailing at the time of the interest rate change and how the change is perceived. The effects may also vary over time.

Monetary policy influences the economy with considerable and variable lags. Analyses performed by Norges Bank indicate that a substantial share of the effects on inflation 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. 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.

The inflation target provides the framework for monetary policy. Norges Bank's Executive Board makes decisions about changes in the interest rate. The members of the Executive Board are collectively responsible for the Bank's decisions. The Executive Board meets every three weeks. At every second meeting, the Executive Board discuss monetary policy in depth. Decisions regarding changes in the interest rate will normally be made at these monetary policy meetings. The Executive Board discusses the economic outlook at a separate meeting three weeks before the *Inflation Report* is presented. On the basis of preliminary projections for the report, the Executive Board assesses the outlook for inflation in two years and the uncertainty surrounding these projections. The following day, the Executive Board summarises its discussions and assesses the consequences for monetary policy for the next four months. This assessment constitutes an important internal reference point when the Executive Board later makes a decision regarding the interest rate. It will also provide the basis for our external communication through speeches and the media. The Executive Board's decision is published in a press release immediately after monetary policy meetings every six weeks.

Inflation in Norway is determined by both domestic and international inflationary impulses. Domestic inflationary impulses are influenced by the situation in the Norwegian economy. Wage growth, demand for goods and services and competitive conditions are very important for price inflation. International inflationary impulses come via prices for imported consumer goods and intermediate goods. These impulses will be affected by developments in international commodity prices, consumer prices and the exchange rate.

The international environment

Uncertainty surrounding international developments is 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 is no longer a reliable guide. Signs of a recession in the US, Japan and other Asian countries have become increasingly clearer and European countries are marked by stagnation.

The situation has shifted rapidly in the US, following strong growth throughout most of the 1990s. This is reflected in both the stock market and household expectations. The terrorist attacks occurred at a time when the economy was very vulnerable. The consumer confidence indicator fell sharply in October. Retail sales figures for October may nevertheless indicate that consumers have started spending again. Car sales in particular boosted growth in October. Car dealers' interest-free loan offers have contributed to this. Other goods also recorded growth in retail sales. The decrease in interest rates has probably contributed to the attractiveness of purchasing consumer durables like cars and appliances.

The decline in the US has spilled over to the European economies. Channels other than trade have probably had a considerable impact. Expectations may be influenced rapidly.

Industrial output is declining markedly in all major regions in the world economy.

A high correlation between share prices in different countries may be an important channel of contagion. International share prices declined through the summer. After a sharp drop on 11 September, share prices have rebounded and are at the same level as at the beginning of September.

The turnaround also spreads through other channels. Vulnerable economies with large government debt must pay very high interest rates to borrow funds.

Credit risk premia have also increased in the US. The yield differential for different bonds with credit risk measured against government bonds has been high for a long time and has increased in connection with the terrorist attacks.

With the prospect of a decline in their economies, many central banks have cut interest rates. A further reduction in interest rates is expected in a number of countries in the short term (3 months). Interest rates are expected to increase somewhat, however, in the longer term (12 months). Real interest rates are at a historical low in many countries.

Growth forecasts for the global economy in 2001 have been lowered substantially during the year. Earlier, a decline in some regions has often been counteracted by an upswing in other regions. The downturn now appears to be more synchronised than in 1975, 1982 and 1991. During the summer and autumn, there has been a lot of bad news from the global community. Due to the tragic events of 11 September, the picture has become gloomier and uncertainty has increased. Growth forecasts for next year have also been lowered substantially.

We have lowered the projection for GDP growth for our trading partners. It is uncertain when the global economy will recover. Nonetheless, we expect that the reduction in interest rates and the fiscal stimuli that have been initiated in the US and many European countries will contribute to boosting growth in both the US and Europe in the second half of 2002 and the beginning of 2003.

Projections for consumer price inflation have also been revised downwards for our trading partners - by ¼ percentage point in 2002.

The outlook for the Norwegian economy

Through the summer, it appeared that international developments had little effect on Norwegian business and industry. During the autumn, it has become increasingly clearer that the turnaround will also be felt in Norway. The export industry in particular is now encountering lower demand and falling prices. The price of oil has dropped to less than USD 20 per barrel. However, the labour market remains tight. The new guidelines for fiscal policy involve increased use of petroleum revenues and will contribute to maintaining the pressure on resources in the years ahead.

The price of oil has fallen substantially since 11 September. OPEC has now made any production cut conditional on cuts by other producers. In the last few days, the oil price has been around USD 18 per barrel, a decline of USD 10 since 10 September. In the oil futures market, the price of oil is less than USD 20 the next two years. The uncertainty that is factored into the price in the oil futures market is higher now than before the terrorist attacks in the US.

The krone exchange rate measured against our most important trading partners has appreciated by 7% since the spring of 2000. However, the krone exchange rate is about 2.5% weaker than in 1990 and at the same level as in the mid-1990s. The appreciation of the effective krone exchange rate in the last 18 months has largely coincided with the depreciation of the Swedish krona. The Norwegian krone has appreciated by nearly 20% against the Swedish krona since the spring of 2000. The Norwegian krone is more stable against other currencies.

The volume of exports and export prices are falling. Figures from External Trade Statistics indicate a 4.2% decline in the volume of exports and a 3.0% decline in export prices from the third quarter last year to the same time this year. The price of aluminium is nearly 20% lower than in October last year. Salmon prices dropped by more than 10% during the same period.

Norway's manufacturing output has declined somewhat this year, 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. According to Statistics Norway's business tendency survey, industrial leaders reported a decline in employment, output and new orders from the second to the third quarter this year. Export industries in particular show signs of a weaker trend. Industrial leaders' assessment of the fourth quarter is less positive than their assessment prior to the third quarter.

The labour market has few available resources. Registered unemployment has remained steady at about 2.5% since the beginning of 1998. Long-term unemployment is low. The majority are unemployed for a short period (frictional unemployment). Unemployment has increased somewhat the last few months. Employment growth is limited. In Eastern Norway in particular, unemployment has increased. In the aftermath of the terrorist attacks, the aviation and travel industries have announced job cuts. Cutbacks in the process industry have also been announced.

The new guidelines for fiscal policy will stimulate activity because petroleum revenues will now be phased in to the economy. According to the Government's estimate, the guidelines increase the use of petroleum revenues in the central government budget by an average of about 0.4% of mainland GDP each year from 2002 to 2010.

In the Inflation Report no. 3/2001, we based our projections for fiscal policy on the National Budget for 2002. The new coalition government is calling for a number of changes in a supplementary proposition. They still recommend that the use of petroleum revenues should be increased by NOK 6 billion or 0.6% of trend GDP from 2001. They also propose a reduction of NOK 7.2 billion in direct and indirect taxes (recorded). This is NOK 3.4 billion more than in the original budget proposal. Underlying real growth in central government spending is estimated at 1¼%. This is ¾ percentage points less than the recommendation from the Stoltenberg Government. The limits for the central government budget will be discussed and clarified in a debate in the Storting on 27-28 November.

We expect moderate growth in the mainland economy in the next two years. The projections for GDP growth are approximately in line with the growth potential of the economy. Household consumption and public spending are the main forces underpinning growth. Fixed investment and exports are restraining growth. Solid consumption growth translates into high demand for labour in public and private services, while slow growth in the international economy and lower petroleum investment curbs growth in employment. Given that the labour market remains tight, we expect wage growth to remain high during the next few years.

Inflation projection

An expansionary fiscal policy, growth in private consumption and continued high growth in labour costs contribute to high price inflation on domestically produced goods and services. We also expect a temporary drop in prices for imported consumer goods due to lower commodity and producer prices in the international market, a slower rise in international consumer prices and the 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.

In addition to providing point forecasts, we attempt to analyse the uncertainty surrounding our inflation forecasts. Some manufacturing sectors are experiencing profitability problems as a result of a high cost level and the international economic situation, while demand is high in the sheltered sector. Increased strains in the labour market are exerting pressure on the traditional wage determination process.

However, the balance of risks is marked by the uncertainty surrounding international developments. There are few upside risks internationally and a good possibility that international stagnation will last longer than we have assumed. In this case, there is a good possibility that this will have a negative impact on other private domestic demand.

If growth in the global economy recovers as we have assumed, we expect price inflation to be about 2½% in two years. Meanwhile, price inflation may be somewhat lower due to the downturn abroad and the decline in prices for imported goods. On the whole, it is Norges Bank's assessment that the probability that inflation two years ahead will be lower than 2½ per cent is greater than the probability that it will be higher.