Present-day Stabilisation Policy Challenges for the Central Bank

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For this lecture the organisers have asked me to address the usual subject of "current stabilisation policy challenges for the central bank." I assume that the organisers take this to include current stabilisation policy challenges *from the central bank's point of view* as well, and not just the challenges Norges Bank is directly responsible for. (For the latter, in parentheses, I could have given a very short presentation.)

Some people might just assume that economists tend to grow more and more gloomy as the Norwegian economy fares better and better. For this reason, if anyone finds my present mood unnecessarily gloomy I would immediately like to make it clear that it does not stem from any strange or puritanical disposition in which delight over an event itself provokes worry

Our concern is instead based on indications over the past 10-15 years of our ability - or more appropriately, inability - to stabilise economic fluctuations here in Norway. It has reached the stage where the Norwegian economy fluctuates more widely than that of any other Western European country. Therefore, I will spend considerably more time discussing possible consequences of such fluctuations and why striving for stability can, in itself, be necessary to ensure favourable economic developments in the long run.

Four days ago the government submitted its revised national budget for 1998. In addition to the usual budgetary items, the budget also contained a review both of Norway's relations to EMU and of the krone's future exchange rate regime. It is natural for me to discuss both of these subjects in detail.

Economic developments - the wage settlement

No one can say that the present economic situation could not be foreseen; rather, it is a matter of wanting to see. With this in mind, I would like to return to a summary review from the December 1996 issue of Norges Bank's *Inflation Report* - ie, a year and a half ago. The summary projects continued strong growth and increased capacity utilisation throughout the last half of the 1990s. The projections for the labour market and price and wage inflation were as follows:

A...projections show ... a gradual decline in unemployment to close to 3% in the year 2000. Our projections also show a gradual rise in price and wage inflation, with price inflation estimated at an annual 3% and wage growth at 5 1/2% at the end of the projection period.

If these projections prove accurate, hourly wage costs in the business sector will rise by about 6% more than among our trading partners during the last half of the 1990s.

Last autumn, in Norges Bank's submission to the Ministry of Finance on the economic programme for 1998, we summed up the economic situation as follows (and I quote):

"Based on the total risk outlook for economic trends in the period ahead, Norges Bank perceives the situation to be such that relatively small changes could result in imbalances in several parts of the economy, eg the labour market and property markets. Such imbalances will sooner or later translate into higher price and wage inflation and fluctuations in the real economy as a result of adjustments in the private sector. Norges Bank is of the view that this can be avoided by bringing demand growth down towards the underlying growth rate in production capacity...

(end quote)

Development in the labour market and the wider economy also reinforce the main points of the documents just quoted. If anything, actual developments are perhaps ahead of projected developments. In April, a record 22 000 vacancies were registered - a twofold increase in just over the last 16 months - whereas employment growth was well over 60 000 persons per year. Whereas there were once 20 unemployed people per vacancy, the number today has been reduced to 2.

I would especially like to underline developments in imports as reflected in the preliminary short-term statistics for 1998. The value of Norwegian importation of goods was an entire 25% higher for the first quarter of this year than over the same period last year. Part of this increase can be explained by the fact that Easter this year fell in the second quarter rather than in the first as it did last year. Still, the rise in imports has been sharp. This primarily reflects a continued rise in demand, but it is also a clear sign of the underlying problem of the Norwegian economy, ie that the supply side cannot meet the increase in demand.

Our projections now indicate that labour market pressure will continue to grow in the year ahead. This is, of course, a decisive factor in estimating how long the cyclical upturn can continue. Given the limitations which must be present in the labour market, the question is not *whether* the downturn will occur, but *when*.

It is possible that some people may interpret this as "alarmist". I concede that the contrast to times of economic upswing can be great. At the same time, I would like to state that the reasoning above is just a description of very simple interrelating economic factors. Anyone these days trying to seek out in-demand services or labourers can confirm this. So, when Norges Bank points out that the potential for high-level growth soon must be exhausted, we are stating nothing less nor more than the obvious.

Our analyses imply that we must expect, sooner or later, the long-lasting and sharp economic upswing to lead to accelerating price and wage inflation. Recent developments are in line, rather than at variance with, the analyses carried out by Norges Bank. That a few people should choose to call them "doomsday prophecies" seems to confirm continued practice of the long tradition concerning the treatment of the bearer of bad tidings.

In the wake of the settlement in the engineering industry in mid-April, settlements in the private sector were reached with fewer complications, insofar as a strike was avoided, than many may have feared would be the case.

Although not all wage settlements have been finalised, and local settlements have not yet begun, there is little to indicate that the last *Inflation Report* projections of 5 1/4% wage inflation is too high.

Many people have suggested that wage increases for the year were unexpectedly high. It has been a long time since we last experienced general wage increases of 10 000 or more. As I see it, however, this is not at all surprising. In the light of historical data on wage formation in Norway, the trend is rather in line with expectations. The result of the wage settlement can hardly be explained primarily as greed on the part of workers or company managers. It is based on economic fundamentals.

To support this view, I would like to present to a chart showing Norges Bank's projections for wage growth over the past five years against projections from Statistics Norway and the Ministry of Finance. For all institutions, projections were made in December of the year preceding the forecast year. Our projections are based on experience of how fundamental economic factors, such as unemployment trends, productivity, and business sector profitability, influence wage growth. As we see here, Norges Bank's projections seem to be rather close to the mark, and we are closer to actual movements than any of the other institutions. But common to the projections of all institutions are expectations of accelerating wage growth.

I think this chart illustrates an important point: The increasing wage growth we are currently seeing is primarily due to the economic policy that has been conducted in recent years, and is now creating pressure in the labour market. So there is no reason for surprise.

Division of responsibility for economic policy

As my listeners no doubt know, there are three main arms of Norwegian economic policy. The social partners are expected to lay the necessary foundation for employment through moderate pay increases, which result in reasonable rises in income while boosting the competitiveness of the business sector. Monetary and exchange rate policy is geared towards maintaining a stable exchange rate against European currencies, while fiscal policy has the main responsibility for ensuring a stable development in aggregate demand.

If the division of responsibility for economic policy is to operate according to intention, however, it is crucial that all policy components function as they are intended to. In the interests of achieving balanced economic growth, a successful interaction between all the different economic policy elements is necessary. I would go so far as to assert that in this respect Norges Bank has delivered according to expectations. Despite some turbulent periods in the foreign exchange market, the krone exchange rate has remained reasonably stable over the past six or seven years viewed as a whole. Nevertheless, the current monetary policy framework has made the tasks of the other components of our economic policy more difficult.

When interest rates have to be used to keep the krone exchange rate stable in relation to European currencies, we normally end up with about the same interest level as the anchor countries. Interest rates in Norway will therefore not be determined by domestic economic conditions, but will be adapted to the economic situation of the anchor countries. In continental Europe, interest rates are currently geared to fairly high unemployment and low capacity utilisation, particularly in Germany and France. The effect is naturally transmitted to us. Norwegian interest rates have basically fallen since the early 1990s, resulting in credit growth and escalating housing prices.

An expansive monetary policy would not necessarily have been a problem in today's situation if fiscal policy had been designed to neutralise these effects. But to date fiscal policy has not delivered according to expectations. The central government budget adopted for 1998 reflects the fact that fiscal policy has shifted from being contractionary to virtually neutral this year. Fiscal policy did not have any particular tightening effect in 1997 either. Our assessment in autumn of 1997 was that a tightening of fiscal policy corresponding to about 1½ per cent of mainland GDP would be necessary to bring the growth rate of the economy down to the underlying trend growth of production capacity.

Now, in the Revised National Budget, the Government has acknowledged the need to tighten economic policy. Despite this, the Revised National Budget does not contain tightening measures of a nature and scope that will effectively damp the pressure in the economy. If fiscal policy is really to be used for stabilisation purposes, this discrepancy between words and action does not seem very appropriate.

Many people will maintain that the undeniably tight fiscal policy of recent years has in fact been an impressive piece of work in view of the large sums of money that have flowed into the Treasury. From a political point of view this may well be true, but the tendency we are now seeing in the Norwegian economy indicates that fiscal policy has still not been tight enough.

What will the future bring

The principal objective of economic policy is to provide a permanent basis for sustainable economic growth and full employment. Very few would disagree on this point. A challenge in this respect is the one we will face in a few years time, when oil revenues begin to decline and in due course come to an end. It will be essential for us to have a competitive industrial sector then, in order to have something to live off.

This does not necessarily mean that it is our present non-oil sectors which will have to sustain the nation 20-30 years from now. In all probability changes will - and should - take place in our industrial sector between now and then. Consequently the question arises as to whether it is advisable to focus as strongly on short-term cost competitiveness as we have done, particularly if this results in strong fluctuations in the economy. Perhaps it would be more appropriate to orient our overall economic policy more towards avoiding such fluctuations.

In its most recent inflation reports, Norges Bank has pointed out that, sooner or later, the strong growth in the Norwegian economy will inevitably give way to more normal growth rates, or at worst stagnation. Our models indicate that a turnaround of this nature may occur at about the turn of the century. Experience both in Norway and internationally shows that major fluctuations in the economy can have costly and lasting effects in the form of unsound investments and labour market mismatches I should like to add some comments to this:

- First, I would contend that major fluctuations in the economy lead to higher average unemployment than that which results if economic growth is more even. Two factors in particular underpin this claim. First, wage formation is not symmetrical at different unemployment levels. In the current situation, with strong pressure in the labour market and relatively low unemployment, experience shows that a relatively moderate decline in unemployment will result in a sharp increase in real wages. If the pressure is great enough, real wages will increase over and beyond what is sustainable a few years ahead. This will in due course result in an economic downturn, with unemployment rising again and wage growth slowing. Given that there is a path for equilibrium real wages which the economy is pressed back to, the result will be a period of high unemployment and more moderate wage growth. But because wage growth will be dampened less when unemployment rises, the period of high unemployment will last longer than the period of low unemployment before equilibrium is reestablished in the economy.

Experience also shows that whereas unemployment increases rapidly during an economic downturn, it takes considerably longer to bring unemployment down again when a turnaround occurs. We tend to say that it is easier for unemployment to go up than down. There is some connection with the so-called hysteresis effects we know exist in the labour market. High unemployment may, for example, trigger various selection mechanisms in the labour market, with the result that unemployment takes on a more permanent nature for certain groups.

- Second, a swift, strong upturn can easily lead to overinvestment and unsound investment. We do not have to go back more than a decade to see clear examples of this. Exaggerated faith in the future may lead to unsound investments which, when the turnaround comes, may lead in their turn to profitability problems and a shedding of jobs, which exacerbates the downturn. This is what we saw at the beginning of the 1990s.

- My third argument is linked to inflation. In previous episodes of overheating, what has normally happened is that inflation was the last to take off, and then only after everything else had gone very wrong. On the other hand, inflation is difficult to bring down again, and it has claimed some fairly significant victims once it has reached a high level.

In addition to the factors I have discussed above, economic fluctuations may create problems for the financial sector. The high lending growth of recent years - including the traditionally loss-prone industries such as property management, retail trade and hotels and restaurants - calls to mind the previous economic upturn, when the fluctuations in the Norwegian economy had serious consequences for the financial sector. Statistics on commercial building starts show that both growth and level of activity are approaching the peak of the 1980s. The figures are of course influenced by the construction of the new international airport at Gardermoen, and the new National Hospital, but building starts in the industries mentioned above also show a very high growth rate. During the previous upturn we saw that excessive optimism led to overinvestment, which in turn resulted in a sharp slowdown in the years immediately following. Our experience from last time indicates that lending by financial institutions should be very conservative in such a market.

However, there are also important differences between today's situation and the peak of the 1980s. What is different this time is that growth in household debt has been approximately on a level with growth in disposable income, and in recent years households have had positive net investment in financial assets. This, in conjunction with substantial revaluation gains, has resulted in an appreciable increase in financial wealth. Households' financial position - viewed as a whole - has thus improved considerably since the end of the 1980s. For most households, however, a stable labour market trend is the most important factor for sustaining debt-servicing capacity.

For the financial sector, the strong growth in credit represents a major challenge in a number of respects. Bank balances show that lending growth has resulted in a lower core capital ratio, because earnings have not been high enough to accommodate the strong growth in lending. In the short term this does not represent a very great problem. Banks' average capital adequacy is still satisfactory. However, capital adequacy requirements must be assessed in the light of the risks the banks face, and there may be variations from bank to bank in this respect. If banks' lending growth is maintained at a high level, a number of key institutions will need to boost their core capital in the longer term. Increased earnings, reduced dividend payments and higher equity payments will maintain or improve capital adequacy. Alternatively, banks can counter the problem of diminishing soundness by reducing growth in the balance sheet.

In recent years, growth in deposits has been lower than lending growth. Banks have thus had to finance a substantial part of their lending growth from other sources. The chart shows that foreign funding has increased substantially over the past two years, and at end-February this year amounted to over NOK 190bn. A substantial share of this consists of short-term loans, which means that banks' vulnerability to the disappearance of short-term financing has increased.

Our own experience from the end of the 1980s and the serious problems a number of Asian countries are experiencing at present show how swiftly a period of optimism and economic growth can give way to a downturn with major real economic costs. These experiences also provide a clear demonstration of how important moderate, controlled risk exposure in the financial sector is for the achievement of stable developments in the real economy.

Banks' net interest income has dropped as a result of strong competition in segments of the financial sector. In my view, there are a number of factors that will contribute to maintaining or possibly heightening this competitive pressure. One of these is technological innovations, which make it simpler for new foreign financial institutions to offer services in the Norwegian financial market and which also make it easier for new operators to compete with banks in certain segments. Another factor is the introduction of a common currency in much of Europe. The introduction of the euro may reinforce a number of the trends we have already been witnessing for some time, with increased internationalisation and competition across national boundaries.

EMU and consequences for Norwegian monetary and exchange rate policy

Monetary policy must also be viewed in the light of the events taking places around us these days. Just over two weeks ago, the most recent and final decision was made regarding the establishment of Economic and Monetary Union in the EU. From the beginning of next year, eleven of the EU member countries will share a common currency. This is one of the greatest monetary reforms of this century.

Since 6 May 1994 we have had an Exchange Rate Regulation that states that "monetary policy must be aimed at maintaining a stable krone exchange rate against European currencies, based on the exchange rate maintained since the krone was floated on 10 December 1992." On 6 May this year the Government announced that this regulation will remain in force after the final phase of EMU is implemented. This is in line with advice from Norges Bank based on the principle that Norway must continue to have a stable exchange rate as operational objective for monetary and exchange rate policy, and that the degree of flexibility in the conduct of monetary policy is not to change. We maintained additionally that the existing guidelines permit a certain flexibility in the conduct of monetary policy, in that no central exchange rate with appurtenant fluctuation margins is stipulated for the krone.

One possible alternative to maintaining the present Exchange Rate Regulation might be to stabilise the krone against a trade-weighted basket that expresses the effect of the exchange rate in terms of changes in the average competitiveness of manufacturing. In the event, this would have resulted in a return to the basket system we had in the period 1978-1990, but with a regulation that allows greater flexibility in the krone exchange rate than was the case then. If we had succeeded in stabilising the value of the krone measured against a trade-weighted basket, fluctuations in international currency markets would not affect the average competitiveness of manufacturing industry.

As we see from the chart, however, historically there have been relatively small differences between the exchange rate index for the EMU countries and the trade-weighted exchange rate.

Historically, there have also been smaller differences in interest rate movements than one might imagine.

A change in the monetary policy guidelines would have undermined confidence in the market under any circumstances. This meant that there should be relatively weighty reasons before any such changes were made. On the matter of changing the exchange rate regime to a trade-weighted basket, however, no such weighty reasons appeared to exist. In the interests of continuity and confidence in monetary policy, Norges Bank therefore advised the Government to maintain the existing guidelines for monetary policy.

The Exchange Rate Regulation provides no concrete guidelines as to which European currencies the value of the krone should be stabilised against. In practice it is often assumed that this means that the value of the krone should be stabilised in relation to the ECU. However, the ECU - which is a basket of twelve of the EU countries' currencies - is a synthetic currency which will not be of any practical interest once the euro has been introduced.

As the foundation for Norges Bank's conduct of monetary policy, the euro will be the most important European currency, just as the ECU today is a key parameter. The exchange rate between the ECU and the euro will be set at 1:1 on the changeover date. Current guidelines can thus remain in force without a change in the international value of the krone, and the krone's initial range against European currencies - as defined in the Exchange Rate Regulation - can continue to apply.

Summary

The establishment of EMU and introduction of the euro will thus probably have relatively limited - if any - consequences for Norwegian monetary policy. Nor has the focus of my talk here today been centred around this subject; rather, it has been concerned with the unstable developments we are currently seeing in the Norwegian economy.

On a number of occasions, Norges Bank has called attention to the signs that our economic policy is under strong pressure. At present it seems as though neither monetary policy nor fiscal policy is helping to stabilise domestic developments. It looks as though the authorities have assigned rather a large share of the responsibility for stabilising the economy on the social partners. As I mentioned previously, in my view this is a responsibility beyond the means available to the partners. In order to continue the successful approach the social partners have followed to date, it would undoubtedly have been easier if economic policy had underpinned the policy of moderation more strongly by stabilising economic development. Since monetary policy is focused on stabilising the krone exchange rate, this is the task of fiscal policy.

Norges Bank has also pointed out that, sooner or later, the strong growth will inevitably give way to more normal growth rates or, at worst, stagnation. Our models indicate that such a turnaround could come at around the turn of the century. The stronger the growth in demand, the more abrupt the turnaround will be when the supply side of the economy starts to impose restrictions. Developments so far have confirmed that our projections have been well founded.

I hope that I have succeeded today in convincing at least some of those present that large fluctuations in the economy can have costly and lasting consequences. Repeated warnings about the economic trend appear to have fallen on deaf ears, however. They have certainly not led to any tightening of economic policy. Perhaps this is not surprising. There does not appear to be any political will, or political support for measures that could effectively reduce the pressure in the economy. Nobody wants changes, inconvenience, or belt-tightening in a situation such as the one we are experiencing now. In a sense we are in the great distribution policy phase, during which the political system appears to benefit from making everybody happy. We tend to forget that economic policy, in the current phase of the business cycle, demands measures that people do not like here and now, but applied in a manner that makes people understand that it is nevertheless for their own good in the longer term.

As I mentioned by way of introduction, history is full of examples of bearers of bad tidings who were paid little heed at best. The popularity of such messengers is by no means enhanced by their turning up while the party is still in full swing. This does not necessarily mean that it is not time to end the party, while there is still hope of limiting the unpleasantness of the morning after.

Thank you for your attention.