Svein Gjedrem: Monetary policy and the outlook for the Norwegian economy

Address by Mr Svein Gjedrem, Governor of the Norges Bank, at the Wage Bargaining Conference of the Electricians and IT Workers' Union in Vestfold and Telemark counties, Drangedal, 24 August 2001.

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The objective of monetary policy

In spring this year, the Norwegian Government and the Storting (Norwegian parliament) laid down new guidelines for economic policy. The Government has announced that it will use the expected real return on petroleum revenues in the Government Petroleum Fund over the central government budget. The Government stresses that it will nevertheless use fiscal policy to smooth fluctuations in employment and activity levels. At the same time, Norges Bank was given a new operational mandate for monetary policy. Norges Bank shall set the key rate with a view to maintaining low and stable inflation. The inflation target is set at 2½ per cent.

Low and stable inflation is the best contribution monetary policy can make to growth and prosperity. High and varying inflation weakens growth potential. The function of prices as a vehicle for information is impaired. Many choices will be based on a false foundation. Pay increases may be cancelled out by high price inflation. With high and varying inflation, it is difficult to determine whether higher house prices, for example, entail a real increase in the value of property, or whether the rise in prices is mainly due to a decrease in the value of money. In an environment of substantial uncertainty, both homeowners and homebuyers make wrong decisions more frequently. Lenders protect themselves by imposing high risk premiums on loans for which enterprises and individuals in the start-up phase pay dearly. Uncertainty has a price. High and variable inflation leads to an arbitrary redistribution of wealth and income. Thus there is no conflict between distribution policy objectives and the objective of low and stable inflation.

Unexpected swings in the price level may easily lead to fluctuations in the real economy and instability in financial and property markets. Experience shows that high inflation does not result in more jobs or lower unemployment, and that the booms associated with high inflation are followed by recessions.

Since the beginning of the 1990s, inflation has been low and employment has grown sharply. Pay increases measured in kroner have been lower than in the 1980s, but low inflation has nevertheless generated stronger growth in purchasing power for wage earners than in the previous decade.

The implementation of monetary policy

Price and cost inflation are influenced through a number of channels. When interest rates rise, it becomes more costly to take up loans and more profitable to save and to postpone consumption and investment. A rise in interest rates will also reduce demand, because the value of houses, leisure homes, cars and shares decreases. Household wealth declines. A rise in interest rates may also strengthen the krone. A stronger exchange rate will curb the rise in prices for imports, which directly and indirectly account for 40 per cent of goods and services in the consumer price index. A stronger krone weakens earnings and reduces activity in enterprises in the internationally exposed sector. This has an impact on enterprises' capacity to pay, wage growth and price inflation.

We do not expect a change in interest rates to have an immediate effect on inflation. Our analyses indicate that a substantial share of the effects of an interest rate change occurs within two years. Hence, the key rate is set with a view to achieving an inflation rate of 2½ per cent two years ahead.

The social partners will take account of the inflation outlook in their wage negotiations. If there are prospects of higher inflation, the nominal wage increases will be higher. At the same time, higher wage growth means higher inflation. Developments in the labour market and wage formation are therefore important for interest rate setting in Norges Bank. It is also important to be aware that developments in labour costs may influence inflation, growth and employment differently in a system with a floating exchange rate that in a system with a fixed exchange rate. In our open economy, with a floating exchange rate, it can be assumed that an increase in wage growth of one percentage point without any monetary policy response will gradually translate into a corresponding increase in price inflation unless wage increases are anchored in higher productivity.[1]

When Norges Bank concludes that the key rate should be changed, the change will in most cases be made gradually. This is because there is normally uncertainty about the situation in the economy, potential disturbances to the economy and how fast an interest rate change will affect price inflation. But we will not always take a gradualist approach. A rapid and pronounced change in the interest rate is appropriate if, for example, heightening turbulence in financial markets or a cost-push shock resulting from negotiations indicates that confidence in monetary policy is in jeopardy.

Norges Bank analyses the inflation outlook in separate inflation reports, which are published three times a year. Further assessments are presented every sixth week in connection with the Executive Board's monetary policy meetings.

Higher interest rates curb demand for goods and services and reduce inflation. Lower interest rates have the opposite effect. If evidence suggests that inflation with unchanged interest rates will be higher than 2½ per cent, the interest rate will be increased. If it appears that inflation with unchanged interest rates will be lower than 2½ per cent, 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 situation in the labour market

The supply of labour is limited in the Norwegian economy at present. We have a tight labour market. The labour force participation rate is high. Extensive use of disability and sickness benefits is limiting the supply of labour. Reforms such as contractual pension schemes, which were expanded through the 1990s, cash allowances for families with small children and an increased number of vacation days this year and next also contribute to reducing the labour supply. Recently, unemployment has declined again. Adjusted for normal seasonal variations, the number of registered unemployed now stands at 59000, or 2.5 per cent of the labour force. Of these, about ¾ percentage point, or about 16 000, have been unemployed for more than 6 months. The tight labour market is the result of a high activity level in the Norwegian economy. Growth in household and enterprise debt is strong. The phasing in of petroleum revenues in the years ahead will keep demand for labour at a high level.

The centralised income settlements in Norway have been an arena of coordination, where considerable emphasis has been placed at times on overall employment. This has contributed to low unemployment levels in our country. But we have also experienced that the income settlements may be a source of economic disturbances. The income settlements in 1974/75 and 1986 in particular, but also the settlements in 1998 and 2000, contributed to higher cost inflation and weaker demand for labour.

We have seen that income formation is affected by labour market conditions and profit trends in the business sector. This is also true of wage and income developments among managers, salaried employees and the liberal professions. The structural changes that now seem to have occurred in income determination for these groups has probably also been important for the outcome of the ordinary wage settlements.

Through the last part of the 1990s, factor income rose as a share of labour costs. Over time, a balance will probably be reached between labour costs and the portion of income that goes to servicing capital. To some extent the process will be self-regulating. High profits tend to lead to stronger growth in wages. Lower earnings prompt companies to cut costs. This may take the form of increased work effort, or possibly workforce reductions, in order to increase productivity. Companies may also reduce growth in business fixed investment.

Since 1997, price inflation has been higher in Norway than among our trading partners. The most important reason for higher price inflation in Norway is that we have had a tight labour market for many years. This has also led to high growth in wages and labour costs. In the light of higher price and cost inflation in Norway than in other countries, it has been appropriate to maintain higher interest rates in Norway than in most comparable countries. Norges Bank increased the sight deposit rate - which is our key rate - by a total of 1½ percentage points last year. So far this year, the key rate has remained

1 The relationship between wage growth and price inflation was also discussed in the Annual Address in February this year.

unchanged. As a result, the difference between short-term rates in Norway and other countries has increased.

The economic outlook

The Bank last analysed the outlook for the Norwegian economy in the June 2001 Inflation Report. Price inflation is projected to fall to 2½ per cent by next year already.

The risk picture is mixed. The Norwegian economy is still characterised by high capacity utilisation. The labour market is tight. There is a risk that domestic pressures may gradually translate into a stronger price impetus than we have projected.

The consumer price index has risen by 2.7 per cent since July 2000. The consumer price index excluding the direct effects of changes in excise duties and energy prices (CPIXE) has risen by 2.6 per cent since July last year, as calculated by Norges Bank. Statistics Norway publishes a consumer price index excluding electricity prices and a consumer price index excluding energy prices. They have a broader definition of energy prices than we use in our calculations. Statistics Norway has not adjusted for the direct effects of excise duties in their indices, but projects that the combined effect of changes in excise duties in January and July will depress the year-on-year rise in the CPI by 0.5-0.6 percentage points in July. According to Statistics Norway, the CPI excluding energy prices and excise duties can then be estimated at 2.2-2.3 per cent.

Whereas the activity level and pressures in the Norwegian economy are high, there is growing uncertainty about developments in the global economy. The Norwegian business sector has so far largely been protected from weaker growth in the global economy, but this may change. Low growth in the world economy may reduce demand for Norwegian products and pressures in the Norwegian economy. It may also help to curb imported price inflation. This could also result in lower price inflation than we have projected.

Against this background, Norges Bank has expressed its view that with an unchanged interest rate ahead, the probability that inflation two years ahead will be higher than 2½ per cent is the same as the probability that it will be lower.