Svein Gjedrem: The inflation target and the floating krone: the interplay between fiscal policy, the interest rate and competitiveness

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to the Executive Board of the Federation of Norwegian Manufacturing Industries, Oslo, 20 March 2002.

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Norway's economic policy is based on the guidelines for fiscal and monetary policy. The guidelines for fiscal policy state that the use of petroleum revenues over the central government budget shall be equivalent to the expected real return on the Government Petroleum Fund. 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 and growth in the economy.

Establishing guidelines for economic policy is not new. Both fiscal and monetary policy have been based on such rules throughout the post-war period, with the exception of the last half of the 1970s and the first half of the 1980s. Monetary policy has had a clear anchor since 1986.

The inflation target provides an anchor for expectations concerning future inflation and interest rates. The inflation target is set at 2½ per cent. Of course, the authorities must stand firm about the figure 2½ if the inflation target is to anchor long-term expectations and if we shall reap the long-term benefits of this conduct of monetary policy. 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.

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 global economy has experienced a slowdown during the last year. The downturn in the US has had contagion effects on European and Asian economies through its impact on world trade and the financial markets. Capital markets are global, and when revenues decline in the US, enterprises with operations in many countries also reduce investment and operating expenses in Europe and Asia. Industrial production has declined markedly in all major regions of the world economy. In Norway, manufacturing output has been more stable.

Norges Bank presented its last *Inflation Report* on 27 February. We expect price inflation to be about 2½ per cent in two years, if growth in the global economy picks up as assumed. The tight labour market will probably continue to result in fairly strong growth in labour costs and rather sharply rising prices for domestically produced goods and services. Annual wage growth is projected at 5 per cent in the period ahead. A subdued rise in prices for imported goods is pushing down overall price inflation. The projections are based on the technical assumption that the krone exchange rate will remain stable. On the whole, the risk associated with the inflation projection is regarded as balanced.

Exchange rates between the major currencies fluctuate widely. The effective exchange rate on the US dollar has risen by more than 30 per cent since 1995. The German mark (later euro) has depreciated by about the same amount. The effective exchange rate for the Japanese yen has fluctuated sharply.

Small countries have also experienced wide exchange rate fluctuations. The Swedish krona has changed considerable in the last 10 years and is now 10 per cent weaker than in the summer of 2000. The Australian dollar has depreciated by more than 30 per cent since the spring of 1997. Countries whose exports include a large component of raw materials tend to experience considerable volatility in their exchange rate. Australia is one example.

Fluctuations in commodity prices entail changes in countries' terms of trade, which measures the ratio of export to import prices. Changes in the terms of trade have an impact on the exchange rate, which in turn dampens the impact on profitability. The exchange rate acts as a buffer. In the 1990s, the fluctuations in Norway's terms of trade were especially wide. Changes in oil prices were an important reason for this. The krone exchange rate has not fluctuated much compared with other countries. The Petroleum Fund acts as a buffer against fluctuations in the oil price, because the Fund's capital is invested abroad. This contributes to stabilising the krone exchange rate.

We must, nevertheless, be prepared for fluctuations in the krone that are more in line with the fluctuations observed in other countries. Changes in the global economy can affect the krone exchange rate. The exchange rate may also react to and contribute to curbing the effects of domestic disturbances.

The floating exchange rate is by and large a well-suited instrument for absorbing unforeseen disturbances to the economy. A stronger krone may, for example, prevent demand pressures from translating into higher price inflation. As history and the experience of other countries have taught us, the real economic losses associated with eliminating high inflation and curbing inflation expectations are considerably higher than those associated with a variable nominal exchange rate. If oil prices fall to such a low level that investment on the Norwegian shelf comes to a halt, a weaker krone would contribute to facilitating the restructuring in the business sector and the rest of the Norwegian economy.

Historically, a stable krone exchange rate has been the nominal anchor in the Norwegian economy. Labour costs among trading partners provided an important reference. Now, the inflation target is the nominal anchor.

The Norwegian krone has appreciated by 2½ per cent since the beginning of 2002 and by more than 8 per cent since the spring of 2000. High interest rate differentials and oil prices have played a part in this development. At present, the krone exchange rate is close to the levels in 1990-92 and 1996. The cost-competitiveness of Norwegian manufacturing companies has deteriorated by 10 per cent since 1996. This is due entirely to pay increases awarded by manufacturing industry's organisations and companies. Underlying this cost inflation is a tight labour market that reflects high growth in employment in public and private services as well as extensive working hour reforms in recent years.

The increase in labour costs is important when Norges Bank assesses the outlook for price inflation and sets interest rates. Excessively high wage growth, both in manufacturing and other industries, will affect the internationally exposed sector through two channels. First, high wage growth will reduce earnings and employment. Second, the interest rate will be increased. Normally, this will lead to an appreciation of the krone, with a further reduction in earnings and employment. Manufacturing will, therefore, feel the effects of excessively high wage growth to an even greater extent than earlier.

At present, the labour market is relatively tight, which is reflected in high 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 than in other countries.

According to the guideline for fiscal policy, the use of petroleum revenues will increase every year for a number of years ahead. This will sustain the demand for labour. The service industries will need more resources. The contest for labour resources will intensify. To contain inflation, monetary policy must probably be fairly tight in the years ahead.

Since 1997, labour costs have increased by between 5 and 7 per cent per year. Nevertheless, the increase in consumer prices has been about 2½ per cent the last couple of years. The krone exchange rate has appreciated since the summer of 2000 as a result of a wider interest rate differential between Norway and other countries. Combined with low growth abroad and increased trade with low-cost countries such as China, this has led to a slower rise in import prices. A higher rise in prices for domestically produced goods and services reflects an increase in labour costs in Norway. As the world economy recovers, import price inflation will probably edge up. A rise in labour costs of more than 5 per cent will only be consistent with the inflation target if the krone continues to appreciate.

In our projections for the Norwegian economy in the next two years, we expect 5 per cent wage growth. As long as wages increase this much, the business sector's competitiveness will decline, thus contributing to a reduction in employment in goods-producing industries.

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. 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 20 years. If this continues to be the case, an average increase in labour costs of around 4 - 4½ per cent in the long term will be consistent with the inflation target.

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 our trading partners' inflation targets. In the long run, this will be offset by a corresponding depreciation of the krone.[1]

The international rise in prices for manufactured goods is lower than for services – around 1 per cent. The inflation target of 2½ per cent implies a depreciation of the Norwegian krone of around ½ per cent in the long term, because the target has been set somewhat higher than our trading partners' inflation target. This means that goods prices measured in Norwegian krone must be expected to rise by about 1½ per cent in the long term. With wage growth of 4 - 4½ per cent, productivity growth in manufacturing must be about 2½ - 3 per cent to maintain profitability. For services, price inflation can be somewhat higher, about 3 – 3½ per cent, and productivity gains correspondingly lower.

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

Historically, employment in the internationally exposed sector has declined in waves. The sharpest declines in manufacturing employment were observed in the years between 1977 and 1984 and from 1987 to 1992. Both periods were preceded by a considerable deterioration in cost competitiveness in manufacturing. There is a risk of a new period of decline in manufacturing.

The restructuring in manufacturing may take place rapidly. Competitiveness has deteriorated by about 10 per cent since 1996. We do not know how long this development will continue. The long-term requirements for improving the balance between wage growth and productivity growth may become apparent at an early stage.

Developments for Norwegian enterprises do not, however, have to be negative. Some enterprises could be at the forefront of technological developments and increase efficiency more rapidly than the relatively high rate of growth in real wages in Norway. Many enterprises move large portions of their production abroad. Norwegian manufacturing companies could still be profitable even if the significance of the manufacturing sector in the Norwegian economy is reduced. 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.

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.