Svein Gjedrem: Monetary policy and wage growth

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to the general assembly of the Employers' Organisation NAVO, 11 June 2002.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 22 May and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

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Norway's economic policy is based on the guidelines for fiscal and monetary policy. The guideline for fiscal policy states that the use of petroleum revenues over the central government budget shall be equivalent to the expected real return on the Government Petroleum Fund. This means that all the capital in the Fund is being utilised. 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 therefore fosters stability in the economy.

Establishing guidelines for economic policy is not new. Both fiscal and monetary policy have been subject to a rules-based framework 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 phasing in of petroleum revenues in the central government budget shall be equivalent to the expected return on the Petroleum Fund. Most of the phasing in of petroleum revenues will take place over the next ten years. With a four per cent return on the Petroleum Fund, the use of petroleum revenues will rise to almost five per cent of mainland GDP in 2010.

The inflation target provides an anchor for expectations concerning future inflation and interest rates. The inflation target is set at 2½ per cent. 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 will occur 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 interest rate is the most important monetary policy instrument. It affects price inflation through two channels: demand for domestic goods and services and the krone exchange rate.

Changes in labour costs influence the rise in prices for domestically produced goods and services. The tighter the labour market is, the higher wage growth will be.

Demand for goods and services determines to a great extent how tight the labour market will be. High levels of private and public consumption, investment and exports will sustain the demand for labour. When the supply of labour is limited, the competition for labour pushes up wages. A tight monetary policy stance with a high real interest rate will curb domestic demand.

In many countries, low and stable consumer price inflation is the goal of monetary policy. Consequently, we can assume that imported price inflation will remain subdued. However, price inflation will nonetheless vary in pace with global economic developments. The krone exchange rate also plays an important role in determining import prices. A strong krone exchange rate will curb prices for imported goods, while a weak krone exchange rate will result in higher prices. When there is a rise in the interest rate in Norway and a widening differential between domestic and foreign interest rates, investments in NOK will increase, and the krone exchange rate will rise.

Price inflation may vary considerably from month to month. This variation may be due to random or temporary conditions, such as fluctuations in electricity prices or petrol prices, or the effects of changes in real taxes.

When we assess the interest rate, we disregard these effects. Statistics Norway has constructed an indicator for adjusted price inflation - CPI-ATE - which is the measure we use to examine the results of monetary policy performance.

A sharp rise in labour costs is currently fuelling brisk growth in the prices of goods and services produced in Norway. Inflation is being kept at bay because the rise in prices for imported goods is close to zero. A stronger krone exchange rate, increased trade with China and eastern European countries, a reduction in tariffs and the global downturn have kept import prices low. If the krone exchange rate remains at today's level, imported price inflation will remain subdued.

Wage growth has remained at between five and seven per cent every year since 1998. It appears that this year's wage settlement will result in a similar outcome. Strong wage growth is the result of a tight labour market.

The interest rate is higher in Norway than in most other OECD countries. This is a direct result of considerably higher nominal wage growth in Norway.

The phasing in of petroleum revenues increases the demand for labour from the public sector and from enterprises selling goods and services to households. With little slack in the economy, employment in the internationally exposed sector must decline.

As competitiveness has deteriorated, manufacturing employment has been scaled back in waves. Competitiveness deteriorated by around 10 per cent from 1994 to 2001. If wages in Norway relative to other countries develop along the same lines as last year and the krone exchange rate remains at the present level to the end of the year, competitiveness will deteriorate further by around seven per cent.

Growth in public spending from last year to this year is estimated at seven per cent. This is considerably stronger than the growth in value-added in the private sector of the mainland economy, which is estimated at around four per cent. The guideline for fiscal policy has been followed closely. Real growth in public consumption is estimated at 1½ per cent. In other words, growth in the production of public services will be moderate, even though public spending is rising sharply in nominal kroner terms because of the steep increase in the cost of producing public services. This reflects high wage growth in the public sector. There have also been substantial increases in transfers to the household sector in connection with our social security system. As a result, most of the strong growth in central government allocations translates into a sharp rise in household consumption, while growth in public service production remains moderate. This is only to be expected when there is steep increase in public sector allocations in an economy where there are no available resources.

Employment and labour force participation rates are high. The labour market is tight. Unemployment remains low, with limited available resources. There will be slow growth in the labour force. Working hours have been reduced by increasing the number of vacation days. In addition, outflows from the labour market have risen over the last few years as a result of early retirement and the use of disability pensions. Strong wage growth generates demands for greater efficiency in both private enterprises and government agencies. Strong wage growth may thereby increase the outflow of discouraged workers to various social security and pension schemes. All in all, we can expect an increase in the labour force of only 0.3-0.4 per cent in the years ahead.

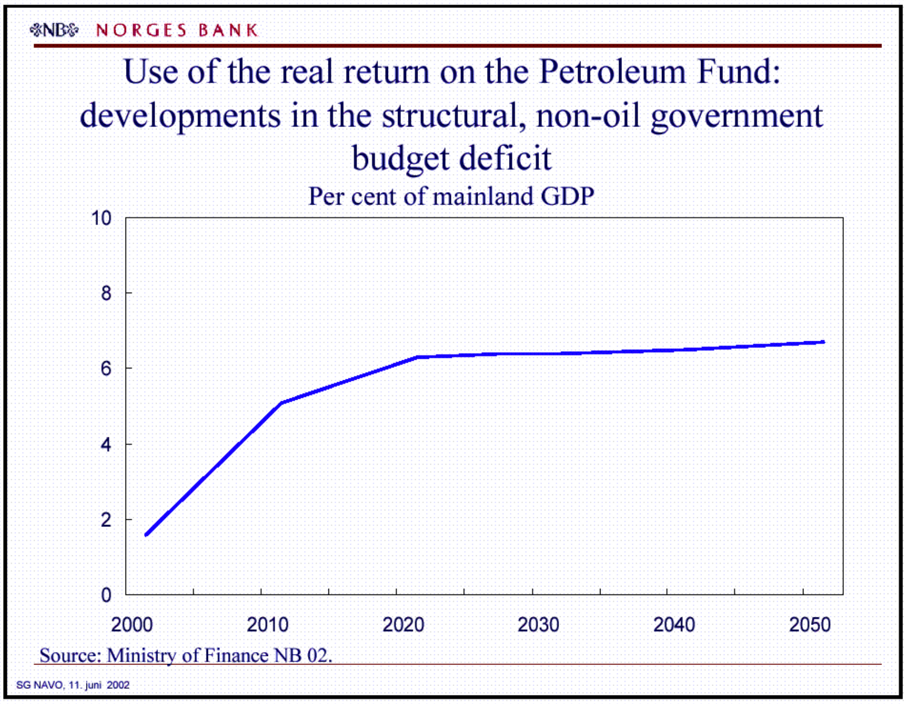
Wage increases in this year's settlement were high. Wage settlements in internationally exposed sectors did not set the trend for wages. Wage increases in these sectors were around five per cent, while they were appreciably higher in a number of sheltered industries. This is a break with the pattern for the past few years.

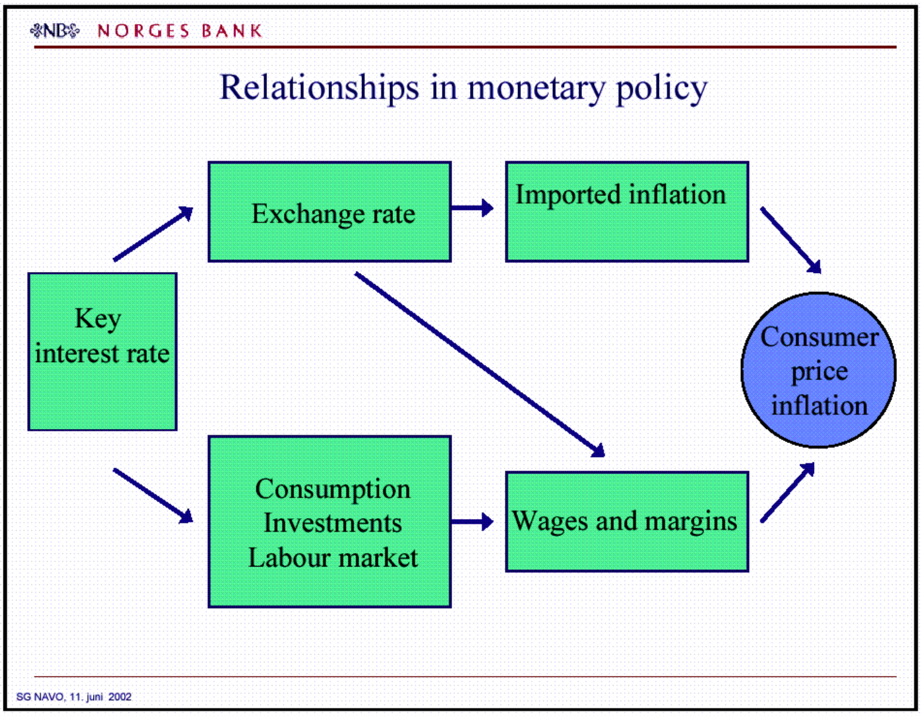
Many enterprises in the sheltered sector can, in principle, pass on higher wage costs to their customers. Monetary policy must reduce the possibility of passing on these costs in order to curb inflation. This is done partly by keeping growth in demand for goods and services under control. In addition, a strong krone may result in the importation of goods and services previously reserved for domestic producers.

In rural areas and towns, where local government employment is an alternative to working in agriculture, the fisheries, local service production or small-scale industry, the public sector, with its nationwide agreements, is a wage trendsetter. Wage growth in the public sector may therefore be an important source of higher inflation.

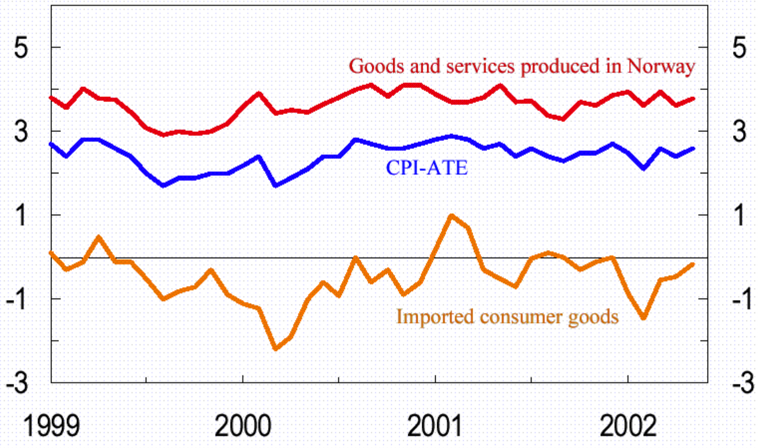
In the public sector, higher labour costs as a result of a costly income settlement can only to a limited extent be passed on to customers. On the other hand, the rise in costs can increase the pressure to raise central government allocations. Many will probably expect the central government to pick up the bill when labour costs rise sharply.

In the business sector - with its profitability requirements - higher labour costs must be matched by an increase in productivity. In principle, the central government will impose the same requirements on government agencies. How these requirements will be met in practice will have a decisive impact on developments in central government expenditure and, consequently, on the interest rate and the krone exchange rate.



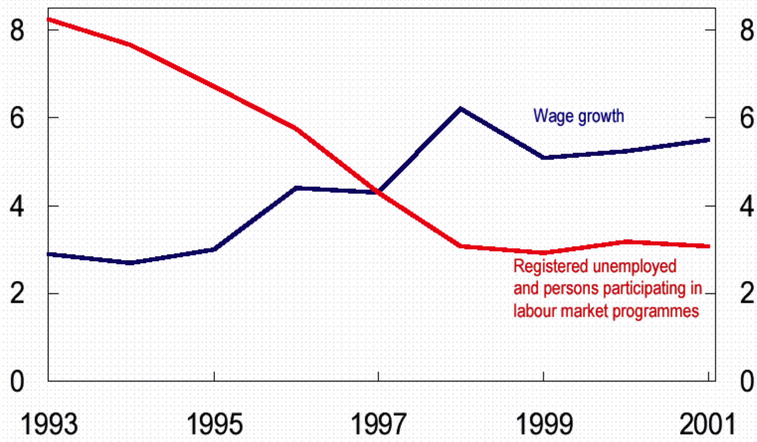


Low imported price inflation pushes down consumer price inflation. Per cent



Sources: Statistics Norway and Norges Bank

Annual wage growth[1)] and the unemployment rate. Per cent

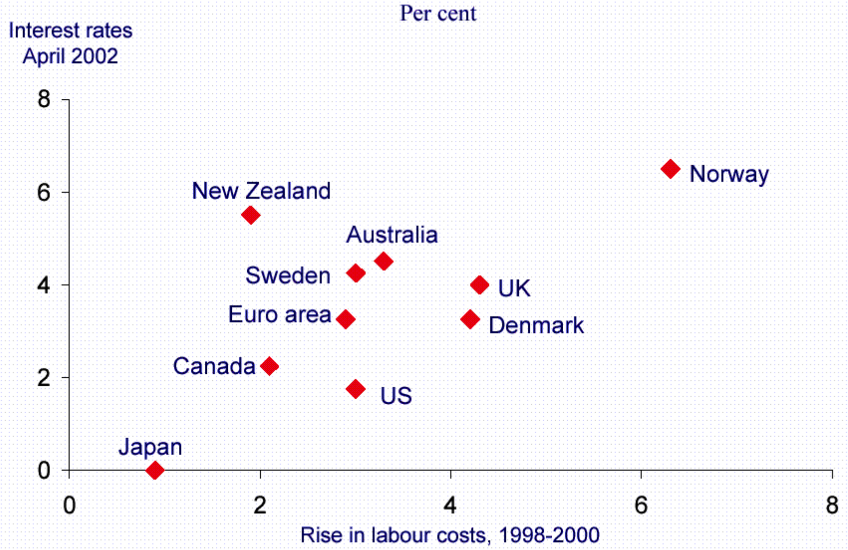


[1)] Average all groups. Including costs of additional vacation days.

Sources: TCI, the Directorate of Labour and Norges Bank

Key rates and rise in labour costs in manufacturing

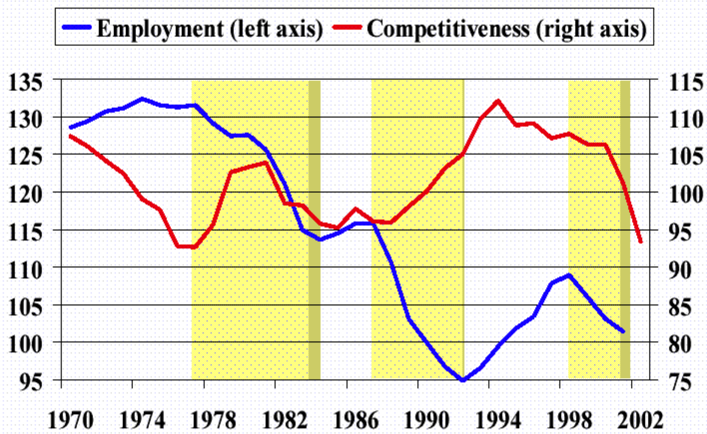
Per cent



Sources: OECD and Norges Bank

Competetiveness 1) and manufacturing employment

Indices, 1990 = 100



1) Relative wages in common currency

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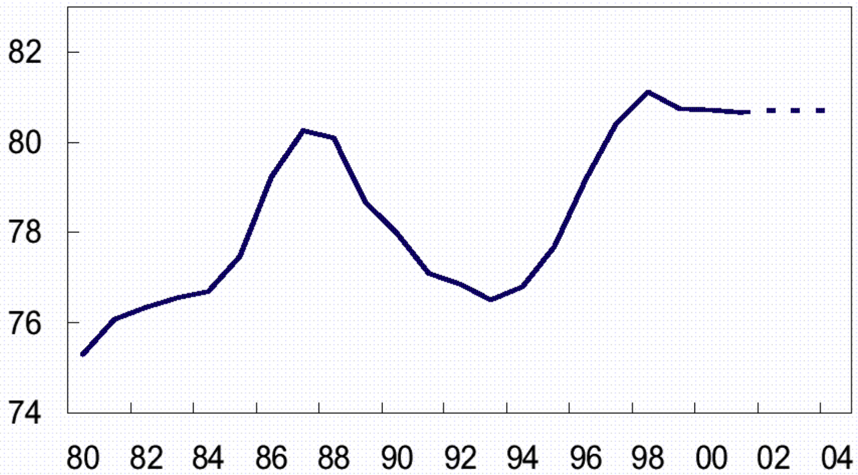
Labour force as a percentage of the population aged 16 to 64 (labour force participation rate)



Sources: OECD and Norges Bank