Jarle Bergo: Monetary policy and cyclical developments

Speech by Mr Jarle Bergo, Deputy Governor of Norges Bank (Central Bank of Norway), at Sparebanken Sogn og Fjordane, Førde, 18 October 2004.

The text below may differ slightly from the actual presentation. The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 22 September, Inflation Report 2/04 and on previous speeches.

The references and the charts in pdf-format can also be found on the website of the Norges Bank.

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Price stability, in the sense of low and stable inflation, is the objective of monetary policy in a number of countries. Historical experience from Norway and other countries has shown that high inflation has resulted in unstable output and employment. In addition, a fall in the price level will often accompany a period of decline.

The first inflation target was introduced in New Zealand in 1990. Canada followed in 1991, the UK in 1992, and Sweden and Australia in 1993. In Norway, the government issued a regulation introducing an inflation target in 2001. Monetary policy in euro area countries and Switzerland is also aimed at price stability, even though this is not referred to as inflation targeting in these countries.

Inflation targeting has proved to be particularly appropriate in very open small and medium-sized economies. Commodity exports play a particularly important role in several of the countries that were the first to introduce inflation targeting.

Current inflation is low, but our recent history shows that without a nominal anchor inflation was high and variable and that we did not achieve higher growth in exchange for inflation. An economic policy that fuels inflation does not generate higher economic growth. On the contrary, it paves the way for subsequent recession and unemployment. High and variable inflation usually accompanies instability in output and employment. But inflation should not be too low over time either. This is partly because the structure of the economy evolves over time. Demand for labour with different qualifications changes. Restructuring requires changes in real wages and relative wages. Nominal wages do not readily fall. With some measure of inflation, real wages and relative wages can be changed without reducing nominal wages. Some degree of inflation oils the economic machinery.

In periods, it will be appropriate to stimulate the economy with low, or even negative, real interest rates. If inflation becomes entrenched at a very low level, the interest rate will be less effective as an instrument because it cannot be set below zero. If the economy is again exposed to unexpected negative disturbances, we will have little scope for manoeuvre.

The most important contribution monetary policy can make to sound economic developments in the long term is low and stable inflation. The inflation target provides an anchor for economic agents' expectations concerning future inflation. We have a very open economy with free capital movements. Stable inflation expectations also contribute to more stable krone exchange rate expectations.

Inflation targeting means setting the interest rate so as to achieve a numerical target for inflation. Norges Bank sets the interest rate with a view to stabilising inflation at 2.5 per cent within a reasonable time horizon, normally 1-3 years. The more precise horizon will depend on disturbances to which the economy is exposed, and how they affect the path for inflation and output.

The inflation target represents a framework for, not an obstacle to, monetary policy's contribution to stabilising output and employment. We have chosen flexible inflation targeting. Variability in output and employment as well as inflation is given weight.

The objective of monetary policy is to safeguard the value of money in the long term, and seek to contribute to stabilising economic developments in the short and medium term.

The objective of monetary policy is low and stable inflation. The instrument is the interest rate. The interest rate influences inflation with a lag and with varying intensity.

As interest rates fall, household and local government consumption and investment tend to accelerate. Higher demand leads to higher output and employment. Wage growth may pick up. Higher wage growth combined with higher profit margins will result in higher inflation.

Lower interest rates normally lead to a depreciation of the krone. Imported goods then become more expensive and inflation accelerates.

Expectations play a key role in price and wage formation, and they are influenced by the interest rate. Expectations concerning future inflation and economic stability have considerable impact, not least in the foreign exchange market.

In the long term, output and employment are determined by the supply of labour, capital and technology and restructuring capacity. Monetary policy can contribute to smoothing fluctuations in output and employment. Norges Bank weighs stable inflation against stable output and employment.

The economy grows over time. Output will in some periods lie below long-term trend growth and in others above trend. Stabilising output growth means seeking to maintain actual output near trend.

The output gap is a measure of the difference between the actual level of output and potential output. Developments in the output gap provide a basis for assessing cyclical developments and can thus also shed light on domestic price and cost pressures in the economy.

It is difficult to know how high capacity utilisation is at any given time. Output and employment figures are often revised and do not therefore always present an accurate picture of the current economic situation. Norges Bank therefore also uses a number of other indicators to gauge the temperature of the Norwegian economy.

The period of high capacity utilisation that began in 1997 came to an end in winter 2003. The Norwegian economy was hit by a pronounced downturn in the global economy. An economic turnaround has now occurred in Norway, with a soft landing after the long period of high domestic cost inflation and sluggish external activity. Output is showing a marked increase, but inflation is low.

Norges Bank has no set target for the level of the exchange rate. Nevertheless, developments in the krone are of considerable importance to interest-rate setting because the exchange rate has an impact on inflation and output. An important channel for monetary policy is the foreign exchange market and the krone exchange rate.

Although the krone fluctuates, the krone exchange rate is not particularly unstable compared with other countries' currencies.

The krone exchange rate is the price of our currency measured in a foreign currency. Developments in other countries are just as important for the krone as developments in the Norwegian economy. Capital flows freely and flows can change rapidly. This can spill over to exchange rates and interest rates as well as output and employment.

There is a cost involved for businesses in hedging against fluctuations in the krone. A krone that is stable - but too strong - also entails social costs in the form of low activity. Similarly, a krone that is stable - but too weak - is a source of high inflation.

From spring 1999 to December 2002, the interest rate in Norway was fairly stable at between 5.5 per cent and 7 per cent. In other countries, the interest rate fell in 2000 and 2001 when the ICT and equity bubbles burst. The interest rate differential between Norway and other countries widened due to cyclical divergence. The period of high capacity utilisation continued for a longer period in Norway, with strong wage and cost inflation. The 2002 wage settlement resulted in very high wage growth for the fifth consecutive year.

The Norwegian economy was exposed to considerable unexpected disturbances from the end of 2002 and in 2003.

Economic developments in other countries were an important factor behind the appreciation of the krone.

In the autumn of 2002 and into 2003, growth in the global economy moved on a different path and was substantially weaker than Norges Bank and other observers had expected. Weak developments in the global economy resulted in lower interest rates abroad and a wider interest rate differential between Norway and other countries. Developments in international equity markets and the risk of higher oil prices also contributed to strengthening the krone.

A persistent downturn abroad, the likelihood of lower wage growth in Norway and a strong krone have led to reductions in the interest rate of more than 5 percentage points since December 2002. The sight deposit rate has been 1.75 per cent since March this year. Monetary policy easing has been aimed at bringing inflation up towards the target of 2.5 per cent and stabilising developments in output and employment.

The decline in interest rates since December 2002 has contributed to weakening the krone. Measured by an index of 44 trading partners (I-44), the krone depreciated through 2003 by almost 11 per cent from its strongest level in January of the same year. The krone has fluctuated moderately in 2004. High oil prices and low interest rates abroad have curbed the effect on the krone of the fall in Norwegian interest rates. The krone has stabilised - though at a high level considering the inflation outlook.

Consumer price inflation in Norway declined sharply through 2003. A number of factors appear to have contributed to the decline.

- The appreciation of the krone through 2002 contributed to a low rise in prices for imported goods.
- At the same time, a *change in trade patterns* and external economic conditions have resulted in an unexpectedly sharp fall in import prices, even when measured in terms of what Norwegian importers pay in foreign currency. The change in trade patterns has made a considerable contribution to the sharp decline in prices for clothing, footwear and audiovisual equipment. Rapid technological advances have also pushed down prices for audiovisual equipment.
- Intensified competition in retail trade and other service sectors. Lower prices for imported consumer goods were an important reason for the low rate of inflation recorded in 2003. So far in 2004, services where wages are not the dominant factor have made the most substantial contribution to low prices. House rents have also exerted downward pressure on inflation.

Norway is not the only country where inflation has been low. In Sweden, underlying inflation has fallen sharply. Excluding energy prices, underlying inflation stands at 0.7 per cent. Inflation has also slowed in Finland and Denmark. One explanation for this, common to all these countries, appears to be keener competition, which has led to high productivity growth.

In the first round, heightened competition affects companies' profit margins. But enterprises respond by reducing their costs. This occurs in part in the individual business, but subcontractors also come under pressure to reduce their prices and enhance efficiency. Increased competition therefore triggers higher productivity growth in the economy. Low inflation may thus be matched by higher productivity.

Economic developments

External cyclical developments and events are of considerable importance to developments in the Norwegian economy.

In autumn 2003, activity in the global economy picked up from a very low level. After rising sharply for several quarters, economic growth in the US slowed in the second quarter of 2004. Economic growth has picked up from a low level in the euro area. Growth has also gained momentum in Sweden and the UK. Strong growth in the US and China exerted upward pressure on commodity prices in 2003 and into 2004. A number of central banks have increased interest rates. Interest rate increases are expected in a number of countries.

Oil prices have also risen considerably during the summer. High oil prices constitute a risk factor with regard to developments in the global economy.

In Norway, output growth has picked up after a growth pause in 2003. The interest rate reductions since 2002 have contributed to a turnaround and the economy has experienced a soft landing following the years of high cost inflation in Norway and the period of weak activity in the world economy. Lower interest rates in particular have contributed to sustaining growth in disposable income and private consumption.

Household demand is one of the most important driving forces in the Norwegian economy. Low interest rates, high growth in real income and improved job security are now creating a basis for strong growth in household consumption.

High wage growth over several years from 1998 has eroded the competitiveness of the Norwegian business sector. The nominal krone exchange rate measured by the trade-weighted index is now approximately at the level prevailing in the mid-1990s, while labour costs in manufacturing have risen considerably more than among our trading partners in the same period.

The business sector is still burdened with the loss in competitiveness that is due to high wage increases. The exposed sector has been scaled back. Companies that are still in operation may be in a better position to cope with the high wage level. A more efficient service sector may also have strengthened the export industry. Nevertheless, costs may hamper activity and employment growth.

The cost level with the current krone exchange rate is close to 15 per cent higher than in the mid-1990s and about 4 per cent higher than the average for the past 30-35 years. Norwegian businesses are losing market shares partly because of the strong krone.

The international division of labour is shifting, and in the face of major restructuring it is a disadvantage for Norwegian business and industry that costs are high.

In 2003, both employment and investment fell, although investment picked up somewhat towards the end of the year. Efficiency-enhancing measures will probably continue to mark developments in the business sector this year. This will curb demand for labour and investment growth. Strong competition has resulted in substantial restructuring. In Norway and other countries, manufacturing production is being moved to countries with lower costs.

Petroleum investment is also rising this year and investment growth may continue to be strong in 2005. Petroleum investment has traditionally had a considerable influence on cyclical developments in Norway. If investment in 2005 is as high as estimated in the most recent investment intentions survey for oil and gas operations, petroleum investment will make a strong positive contribution to the Norwegian economy.

Oil price developments have mixed effects on the Norwegian economy. Persistently higher oil prices contribute to higher petroleum investment and increased activity in sectors affected by petroleum activities. A sharp rise in oil prices, however, has restrained global economic growth and affected demand for our other export products.

Increased petroleum investment and exploration activity offshore are providing an impetus to the business sector in the North-West. This is reflected in an increase in incoming orders to the shipyards, following a long period of sluggish activity. The willingness to invest is rising.

The region is very export-oriented. The county of Sogn og Fjordane is Norway’s second largest in terms of exports per inhabitant, while Møre og Romsdal ranks third. After declining in recent years, exports have now picked up in both counties.

Møreforskning in Molde relays information regularly from our contact enterprises in Sogn og Fjordane and Møre og Romsdal. In September, these enterprises reported a rise in demand and output in all industries, with the exception of the fishing and fish processing industries. Output in the construction industry, retail trade and manufacturing output focused on the construction industry have also picked up. The public sector reports considerable investment needs, for example in connection with health sector projects.

This snapshot report on the current situation in this part of the country and similar reports from the other regions provide information that is important to interest-rate setting.

Employment has shown only a moderate increase since last summer, even though output growth has been high. The labour market has thus improved somewhat. The number of persons employed in Norway began to increase in summer 2003 and unemployment stabilised. Adjusted for seasonal variations, LFS unemployment stood at 4.5 per cent of the labour force in July.

The most recent figures from the Directorate of Labour show that in September unemployment rose in the health care sector but declined in manufacturing, construction and science professions. Unemployment has fallen in most regions.

The North-West and Sogn og Fjordane:

In the North-West, there are still only a few contacts that report an increase in employment. Most companies can increase activity by 10-15 per cent without altering their workforce. Retail trade and construction are the only sectors that report an increase in employment. Construction companies report some signs of labour market tightness, due in part to the start-up of work on the Ormen Lange project. The use of foreign contract labour in connection with seasonal work in the fish processing industry, the hotel sector, tourism and the engineering industry is increasing.

Growth in household demand, petroleum investment and increased activity in the business sector are paving the way for a rise in employment in the period ahead. On the other hand, intensified competition and continued rationalisation in the business sector may have a dampening impact on labour demand.

Developments in real economic variables are mirrored in credit markets. In recent years, household income has shown solid growth, and household confidence has been high. Corporate earnings, however, have been low, and until recently companies have primarily focused on enhancing efficiency.

Total credit growth is rising approximately on a par with GDP growth. The composition of credit growth in the past year, however, has given ambiguous signals to our interest-rate setting. Growth in household borrowing is high, while growth in corporate borrowing is low.

Developments in corporate borrowing shadow developments in corporate investment.

Household debt has increased sharply since 1994. The sharp increase in the value of dwellings is one of the main factors behind growth in household debt. House prices have risen by an annual average of around 9 per cent over the past 10 years. High and persistent house price inflation might contribute to holding up credit growth even after prices have levelled off. Since only a portion of the housing stock is sold each year, there will for a long period be some dwellings that are sold at a higher price than when they were last sold. This contributes to sustaining high credit growth.

As a result of low interest rates, the household interest burden will remain fairly low in spite of high debt growth. It may prove to be particularly challenging for borrowers to assess their debt-servicing capacity over time in a period when the interest rate is abnormally low. Such a low interest rate also places greater demands on banks in assessing the creditworthiness of borrowers.

According to money market expectations, the interest rate will eventually stabilise around 5½ per cent. This is consistent with an inflation target of 2½ per cent and a long-term real interest rate on a par with the level abroad. This interest rate, with an addition for banks’ margins, provides a more realistic indication of the interest rate level that will apply over the loan’s life than the floating interest rates prevailing today.

The interest rate can be used to reduce credit demand. At present - with continued low interest rates abroad and a close link between domestic interest rates and the krone - a tighter monetary policy would restrain credit demand primarily because job security would be reduced as a result of a stronger krone.

House prices and developments in household credit influence consumption and housing investment. We seek to take account of these indirect effects in interest-rate setting.

A turnaround has occurred in the Norwegian economy. The economy has experienced a soft landing after the long period of high cost inflation in Norway and sluggish external activity.

- Output has returned to trend and is now showing a marked rise.
- Employment has returned to trend and is rising.
- Unemployment is at the 1996-level and is equal to the average for the 1990s.
- Wage growth is broadly in line with a level that is consistent with the inflation target given normal productivity growth.
- Overall credit growth is balanced. Credit is expanding approximately in line with trend growth in nominal GDP.
- Labour costs in Norway relative to our trading partners are now broadly in line with a long-term average.
- The nominal krone exchange rate is on a par with the average for the 1990s.
- The interest rate level is close to the level prevailing among our trading partners.
- Inflation expectations are approximately the same as the target.

In this respect, there is equilibrium in the Norwegian economy.

But the current inflation rate is low, and external and domestic interest rates are low. Lagged effects of the strong krone in 2002 are exerting downward pressure on inflation. At the same time, a change in trade patterns and external economic conditions are pushing down import prices, even when measured in terms of what Norwegian importers pay in foreign currency. In Norway, intensified competition appears to be resulting in high productivity growth, which is probably contributing to low inflation.

The inflation rate was lower than expected this summer, but picked up in September and is now approximately in line with projections in the July *Inflation Report*.

Growth is high in the Norwegian economy. Monetary policy affects the economy with a lag, and there is always substantial uncertainty surrounding inflation developments.

The fall in the value of the krone through 2003, low interest rates and solid growth in the real economy are expected to gradually push up inflation.

Thank you for your attention.