Svein Gjedrem: Globalisation and monetary policy in Norway

Address by Mr Svein Gjedrem, Governor of the Central Bank of Norway, at the Nordic CFO Seminar, Stockholm, 10 May 2006.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 26 April, Inflation Report 1/06 and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

The Charts in pdf-format can be found on the Norges Bank's website.

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Thank you Madame Chair,

Let me first say that I am glad of this opportunity to address you on the issue of globalisation and monetary policy in Norway.

Effects of increased globalisation

The term globalisation can mean different things to different people, but today I refer to the growing interdependence of national economies as reflected in greater and freer flows of goods, services, capital and even labour across national borders.

The globalisation process has accelerated over the last 15 years through increased trade liberalisation, political changes, technological advances, and a sharp reduction in transaction costs. As illustrated in this chart, cross-border flows of goods and capital are growing at a markedly faster pace than world production.

These developments present challenges to monetary policy. Financial imbalances have been building up internationally as a result of a strong rise in cross-border capital flows and foreign asset ownership. In Norway, we are facing a significantly changed terms-of-trade pattern.

One important feature of the current globalisation wave is the integration of China, India and other emerging economies into the world trade system. This development has been strongest in China, whose share of world exports is growing rapidly. The countries within the Commonwealth of Independent States (CIS) have also increased their exports markedly since the early 1990s. India is at the starting-line.

Many of these economies have large labour forces that offer their services at very low wages, and these labour resources are available to companies that compete on world markets. Low labour costs and more efficient transport and communication attract labour-intensive production. Production of goods and services is being transferred from high-cost countries to countries like Estonia, Latvia, Poland, China and India.

This shift in the international division of labour is now influencing real wage growth in industrialised countries. The risk that a business will have to wind up operations or move abroad is dampening cost pressures, as bargaining power is being transferred from workers to employers. In a number of European countries, wage growth is also being influenced by increased labour inflows from the EU accession states.

As Scandinavian consumers, we are benefiting from falling prices for many imported goods. Lower import prices are also ascribable to a shift in our imports towards a higher share of imports from low-cost countries.

The change in clothing prices in Norway may serve as an illustration. Prices rose by around 3 per cent annually for a long period, but since 1995 they have been falling by about 6 per cent annually. This kink point coincides with the dismantling of the restrictions on textile trade and with a period of rationalisation in retail trade in Norway.

The rapid growth of production in China, India and other newly integrated economies has led to a substantial rise in demand for oil and other raw materials. At the same time, increased trade has engendered higher demand for shipping services and favourable freight rates for a period.

These changes have provided Norway with increased revenues thanks to a remarkable strengthening of our terms of trade. Prices for imported goods are falling in relation to prices for goods we export. The impact of the rise in oil and gas prices is particularly strong, but the terms-of-trade gains on goods in the mainland economy have also been high.

The situation in Norway differs from that of its Nordic neighbouring countries. Sales of Swedish and Finnish high-tech products are growing strongly in terms of volume, but prices are falling. Denmark has a diversified business sector, which is moving on a steady path overall.

The high energy prices have contributed to increased cross-border capital flows as income is transferred from oil importers to oil exporters. Consequently, a savings surplus has been building up in oil exporting countries such as Norway.

Globalisation has also had an impact on the functioning of international capital markets and has created considerable global imbalances. The US trade deficit increased to over 6 per cent of GDP in 2005, while oil exporting countries and East-Asian countries are running large current account surpluses and building up high levels of international reserves.

The increased savings of oil exporters as well as of some emerging countries have pushed down international interest rates. Bond yields have been low, and have stayed low even when short-term interest rates have been raised. However, in recent months bond yields have picked up somewhat. Although the world's central banks have pushed short-term interest rates in recent years to their lowest level for a century, this has not led to a significant rise in inflation.

Challenges to monetary policy

The Government has defined an inflation target for monetary policy in Norway. Norges Bank's conduct of monetary policy shall be oriented towards low and stable inflation, with annual consumer price inflation of close to 2.5 per cent over time. Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment.

Since summer 2003, the Norwegian economy has experienced a marked upturn. While it took some time for employment to pick up, this is occurring now. Employment is moving up and unemployment is falling rapidly.

Although inflation has increased somewhat, it is still low, even 2½ years after the cyclical change. The trend in prices for consumer goods over the past two or three years is a result of a favourable supply shock to the Norwegian and global economies. Low inflation is being accompanied by real income growth and a rise in production.

Since last summer, monetary policy in Norway has been oriented towards a gradual increase in the interest rate – in small, not too frequent steps – towards a more normal level. On the basis of current information, this interest rate path provides a reasonable balance between the objectives to be given weight by Norges Bank in its conduct of monetary policy:

- On the one hand, the objective of bringing inflation up to the target and anchoring inflation expectations suggests in isolation that interest rates should be kept at a low level until there are clear signs of higher inflation.
- On the other hand, the Norwegian economy is growing at a solid pace. Capacity utilisation is slightly above the normal level and increasing, and house prices and household debt are rising sharply. In isolation this would call for a tightening of monetary policy.

Norges Bank has decided to use some time to bring inflation back to target and has chosen to gradually shift to a less expansionary stance.

The assessments of economic developments ahead will determine how gradual the interest rate increase will be. Our current assessment implies an interest rate path where the interest rate is raised by about 1 percentage point this year. This is also in line with expectations in the money and foreign exchange markets.

The interest rate was last raised in March. In line with the forecast in the March Inflation Report, there are prospects of another interest rate increase in the second quarter – at the monetary policy meeting in May or June – and a further increase thereafter.

Conclusion

Increased globalisation and the ensuing terms of trade improvements have exposed the Norwegian economy to a significant upward income shock. This has amplified the domestic upswing. So far, however, strong growth impulses have not led to major imbalances in the labour market or strong upward wage and price pressures.

This may be seen as an indication that the macroeconomic framework, most notably the fiscal and monetary policy regimes, has been quite successful so far in shielding the Norwegian economy from excessive fluctuations. More importantly, as long as we adhere to the macroeconomic framework, it will shield the economy when oil prices eventually fall and our terms of trade are reversed.

Thank you for your attention!