Svein Gjedrem: The conduct of monetary policy

Introductory statement by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 10 May 2007.

Please note that the text below may differ slightly from the actual presentation. The statement is based on Norges Bank's Annual Report for 2006, Monetary Policy Report 1/2007 and the Executive Board's assessments in the period to the monetary policy meeting on 25 April.

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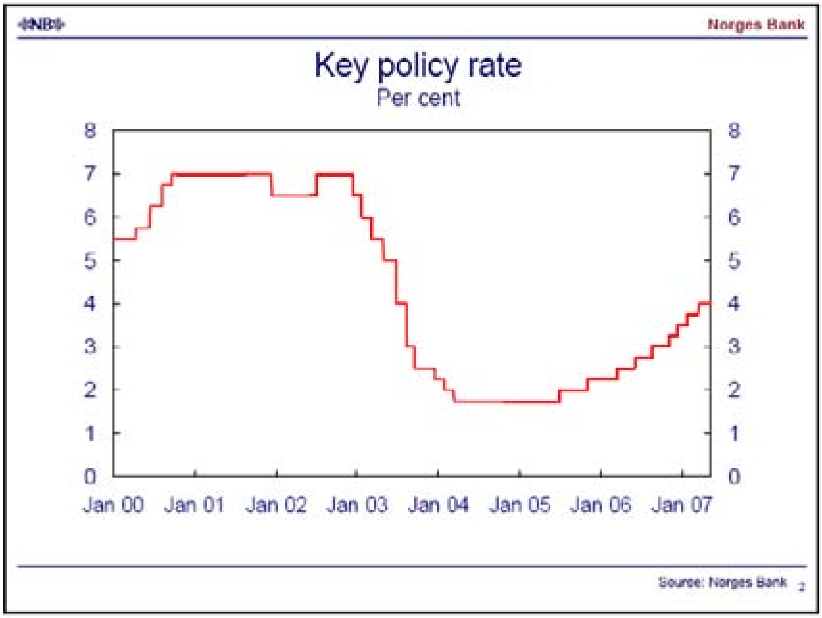
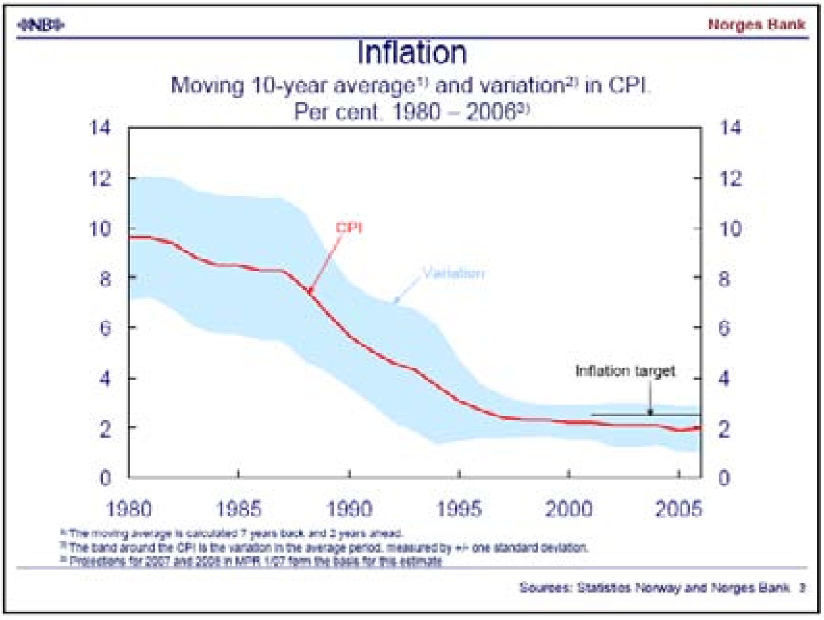
I would like to thank the Chairman of the Committee and thank you for this opportunity to report and answer questions on monetary policy in connection with the Storting's deliberations on the Government's Credit Report. The account is based on the Bank's Annual Report, but is also updated based on the Executive Board's assessments in the period to the previous monetary policy meeting. We also consider the report from Norges Bank Watch.

In recent years, the Norwegian economy has been influenced by a number of positive supply-side conditions, which have curbed inflation, increased the growth potential of the economy and boosted production. At the hearing in 2006, I indicated that inflation would pick up. Rising capacity utilisation and a tighter labour market were expected to lead to higher wage growth. There were prospects of a gradual increase in the key policy rate to a more normal level.

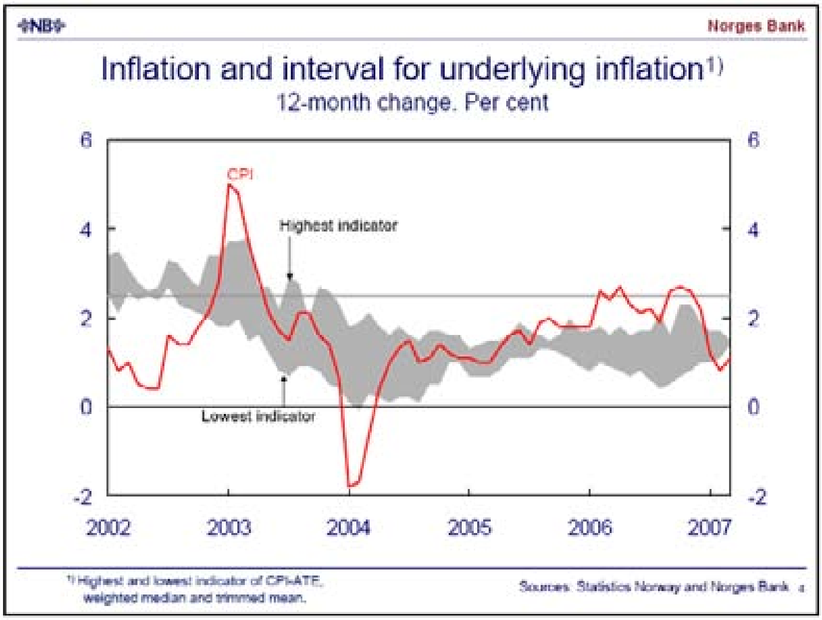


Through 2006 and into 2007, inflation was lower than expected, but output and employment were higher than expected. Norges Bank has increased its key policy rate by 1½ percentage points in six increments over the past 12 months. By way of introduction, I will take a closer look at the assessments underlying the interest rate decisions.

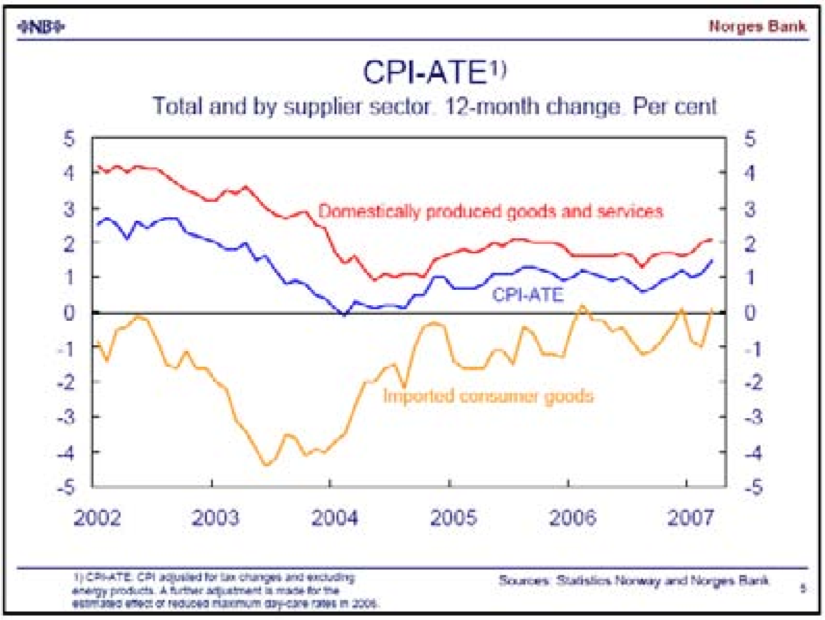
Monetary policy in Norway is oriented towards low and stable inflation. The operational target of monetary policy is annual consumer price inflation of approximately 2½ per cent over time. The objective of low and stable inflation provides the economy with a nominal anchor. In a small, open and decentralised market economy like Norway, and with our particular industry structure, cyclical fluctuations will occur in periods. When economic agents are confident that inflation will be low and stable over time, the interest rate can also be set with a view to dampening fluctuations to some extent.



In Norway, inflation fell sharply as from the latter half of the 1980s. As a 10-year average, inflation is now 2.1 per cent, which is somewhat lower than, but fairly close the target of 2.5 per cent. Annual variability in inflation is considerably lower than in the 1970s and 1980s.

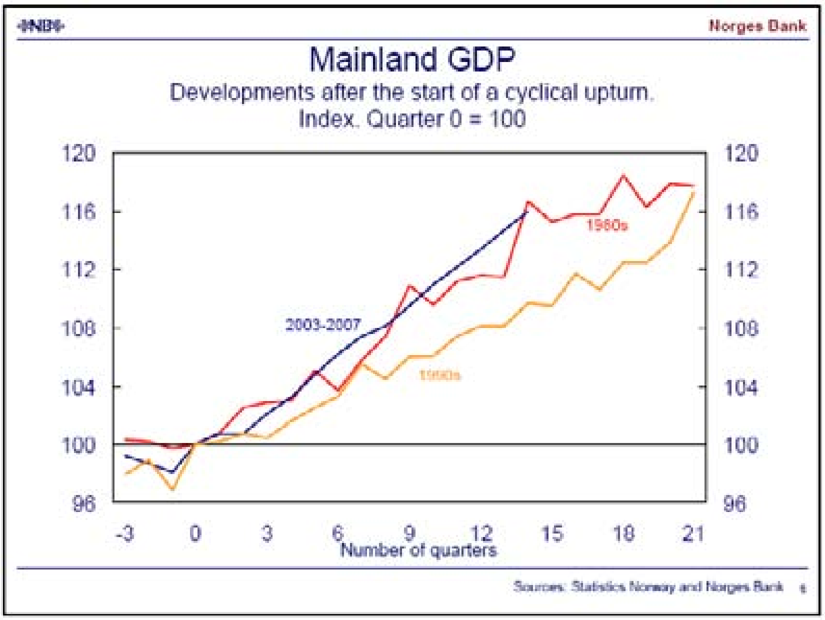


Consumer prices vary from one month to the next, partly reflecting wide variations in electricity prices. In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account in Norges Bank's conduct of monetary policy. We therefore look at different measures of underlying inflation. The chart shows inflation adjusted for tax changes and excluding energy products, CPI-ATE, and two other measures. This does not provide a precise measure, but an interval for underlying inflation on the basis of the different indicators. A weakness of the CPI-ATE as a measure is that the variable has not captured the higher rise in energy prices compared with the rise in prices for other goods and services in recent years. Over the past two and half years, underlying inflation has been fairly stable and is estimated at between 1 and 1½ per cent. The indicators of underlying inflation have recently been in the upper end of this interval.



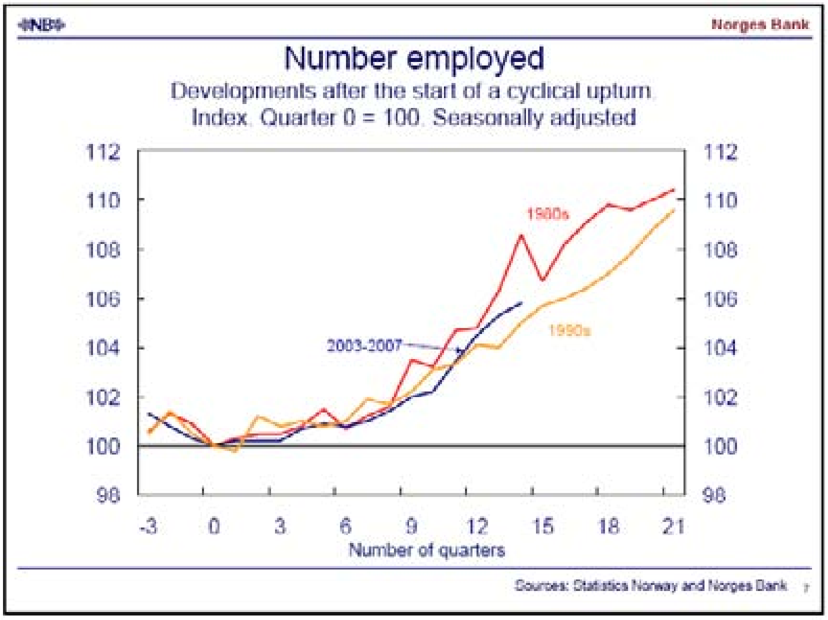
The fall in inflation in 2002 was attributable to an increase in imports from low-cost countries and a strong krone exchange rate. Prices for imported consumer goods fell sharply. In 2003, slower growth in both Norway and other countries also pushed down the rise in prices for domestically produced goods and services. In addition, competition was intense in many industries. In 2005, inflation appeared to be rising, but abated again in 2006, primarily reflecting the low rise in prices for domestically produced goods and services. Prices for imported consumer goods showed a considerable smaller decline than in the three preceding years.

Our inflation projections were revised downwards in the light of actual developments through 2006. Underlying inflation has recently picked up somewhat and is more closely in line with that expected one year ago.

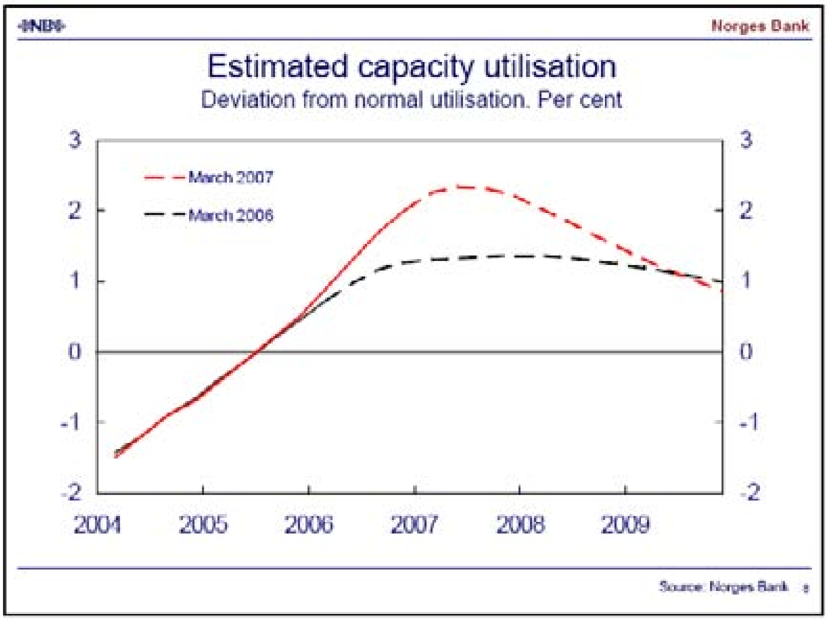


At the same time as inflation has been low, growth in the mainland economy has been strong, and stronger than expected. The Norwegian economy is booming, after a strong upturn since summer 2003. The upturn followed a period of slow growth from 1998 and a mild recession in 2002 and into 2003.

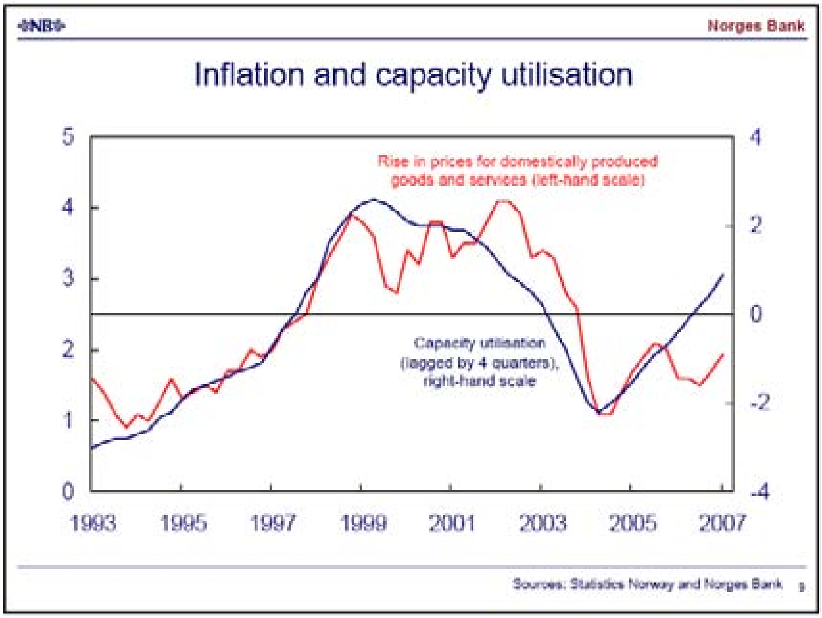
Growth has been stronger and occurred earlier than in the cyclical upturn in the mid-1990s. When Norges Bank reduced the key policy rate in 2003, demand and output rapidly recovered. Strong productivity growth supported the upturn, which was reflected in exports, petroleum investment and after a period in general government demand. So far in this cyclical upturn, the mainland economy has grown by an average of a little more than 4 per cent annually. The upturn is now in a mature phase.



Even though production increased rapidly, it took a long time for employment to pick up. Employment growth was lower for a long period compared with the upturns in the 1980s and 1990s. Moreover, high growth in labour productivity partly reflected a marked fall in sickness absence in 2004. Employment growth was also influenced by the substantial inflows of labour from central Europe following EU enlargement in 2004. Employment did not start to increase until the end of 2005, and has since increased markedly.

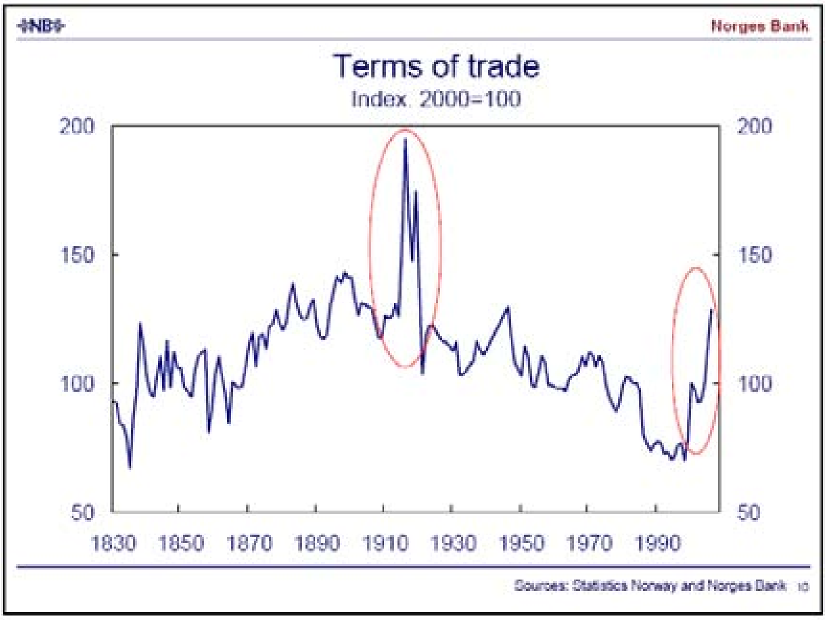


Our projections for capacity utilisation have been adjusted upwards, reflecting stronger-than-expected growth in both output and employment. Capacity utilisation is now estimated to be about 2 per cent higher than a level that is sustainable over time.



In this upturn, it has also taken a long time for inflation to pick up. In the upturn in the 1990s, the rise in prices for domestically produced goods and services picked up in pace with capacity utilisation and with a lag of about four quarters. Correspondingly, inflation fell after the downturn early in this decade. During the present upturn, inflation has remained low so far in spite of solid growth and rising capacity utilisation.

Why has inflation remained that low in an environment of strong economic growth?

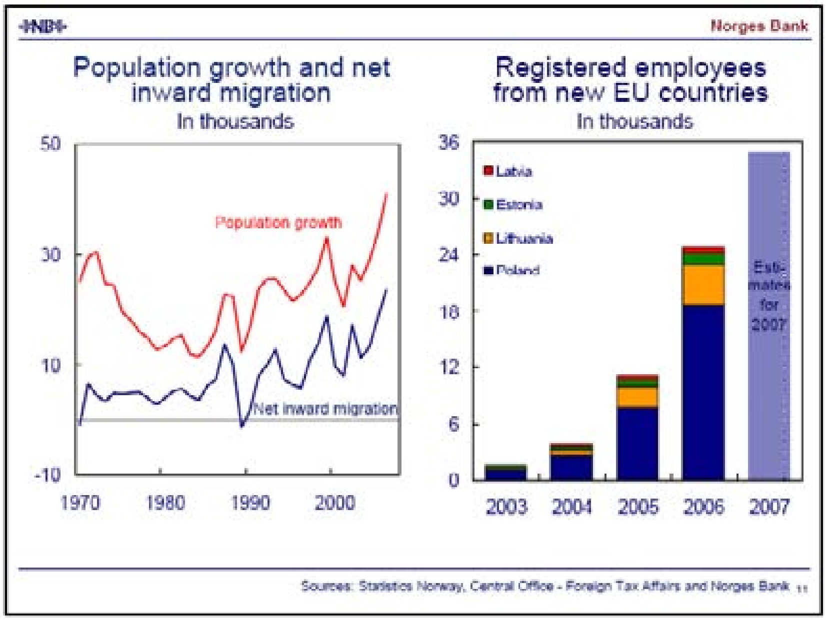


There are probably several reasons for this.[1]

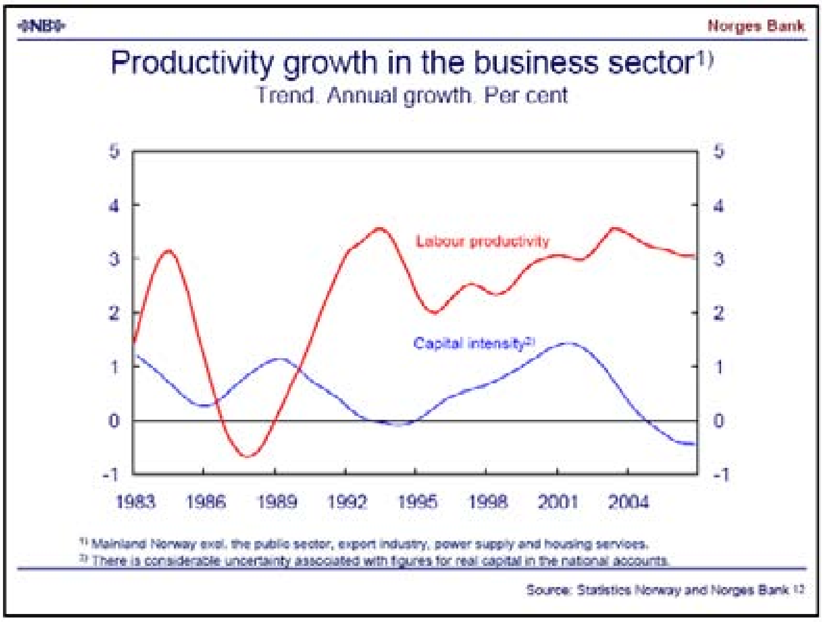
First, Norway's terms of trade have improved. Prices for oil and gas, freight, fish, industrial commodities and engineering products have risen markedly. In addition, growth in foreign markets has provided considerable outlets for Norwegian export goods. At the same time, Norwegian importers have gained access to new markets in central Europe and Asia which provide substantially cheaper consumer goods. Norway's terms of trade have improved by about 40 per cent since 2002. A similar situation has not been seen since World War I when earnings in the shipping industry and other export

[1] See also the analysis in Norges Bank Watch 2007.

industries were exceptionally high for a period. Norway's disposable income increased in real terms by 30 per cent from 2003 to 2006.



Second, an ample supply of labour has boosted output growth. In particular, the supply of foreign labour has increased sharply after EU enlargement in 2004. Over the past two years, these labour inflows have accounted for over 30 per cent of growth in the labour force in Norway. At the same time, this has enabled Norwegian companies to be bolder in accepting new assignments and investing knowing that they can procure labour throughout Europe. In addition to increased labour inflows from Poland, Lithuania and other central European countries, we have long benefited from inflows of labour from Sweden. Many workers are on temporary assignment and their consumption is primarily concentrated in their home country. The Norwegian economy has seen a net capacity increase.



Third, the Norwegian business sector has been quick to integrate new technology. This applies both to companies competing on international markets and those supplying goods and services to the domestic market. In comparison with other countries, it is particularly productivity gains in banks and other service sectors that stand out. Examples are automated processes and swifter payments in the financial industry and improved inventory and management systems in commerce and transport. This results in lower production costs.

The strong growth in labour productivity does not seem to reflect an increase in the real capital behind each person-hour worked, but rather a considerable improvement in labour and capital efficiency.[2]

Intensified competition in product markets may have contributed to the subdued rise in prices. New operators have entered markets that were previously fairly sheltered from competition, for example in the grocery trade, building materials, telecommunications, banking and insurance.

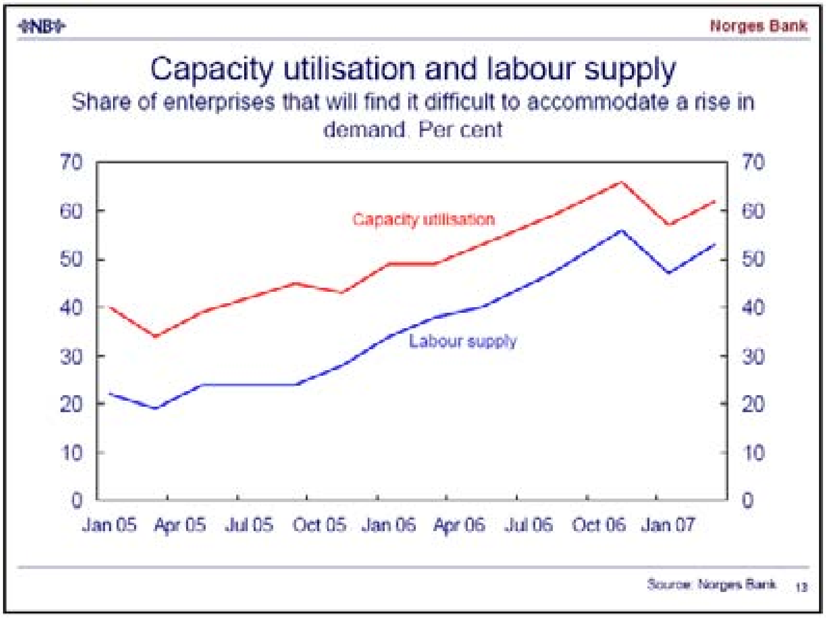
With general confidence that inflation will be kept in check and that petroleum revenues are only gradually phased into the economy, low import prices, high prices and good market opportunities for our export goods, an ample supply of foreign labour and high productivity growth have made it possible to combine high growth with low inflation.

It is possible that some of the driving forces that have boosted the growth potential of the Norwegian economy and restrained inflation may now diminish.

Prices for imported goods are now falling at a slower pace. The shift towards imports from low-cost countries was less pronounced in 2006 than in previous years. The rise in prices for oil and other commodities over several years has resulted in a somewhat faster rate of increase in producer and export prices among our trading partners. Measured in foreign currency, prices for imported consumer goods rose in 2006.

The labour market is tightening in Sweden, Poland and the Baltic counties, which may mean that labour flows from this source may not increase as rapidly ahead.

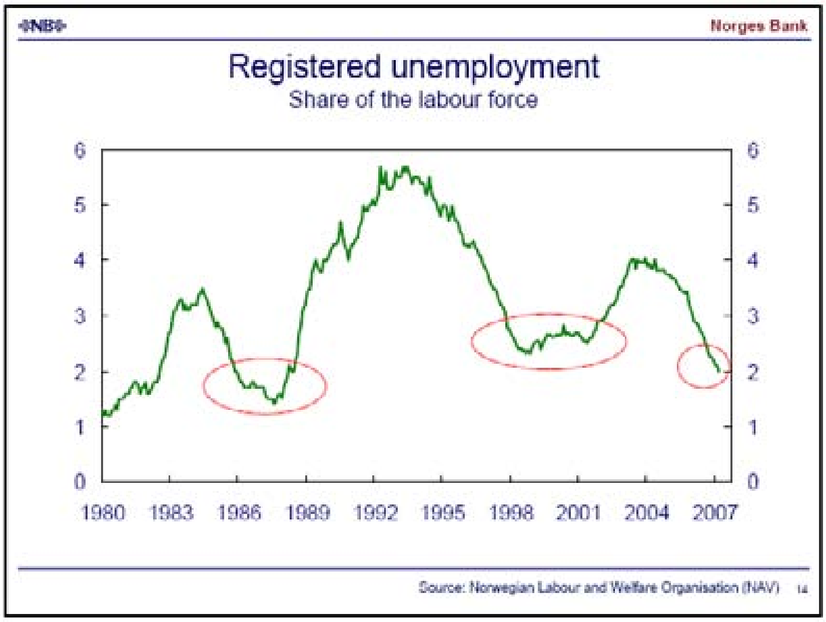
When the cyclical upturn is in a mature phase, productivity growth will normally drop back somewhat.



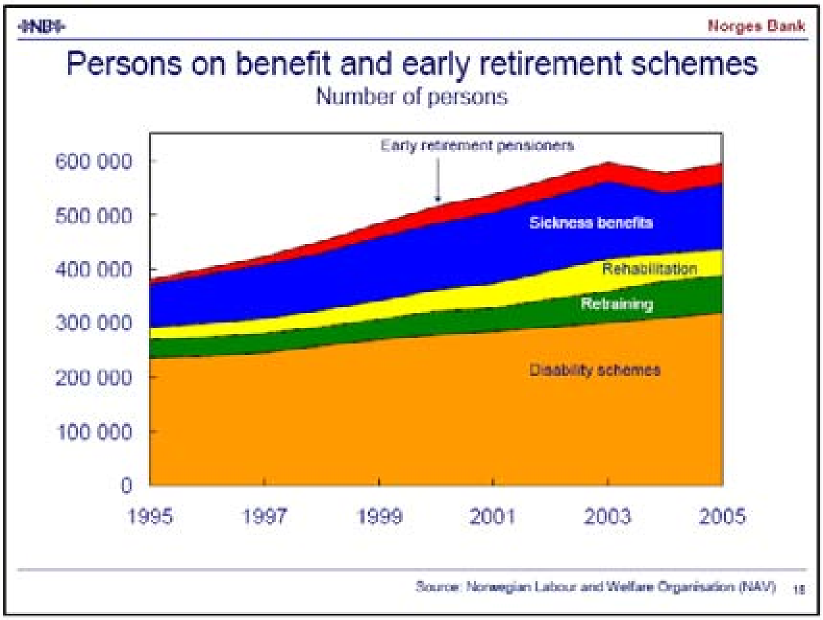
Capacity utilisation is now very high in most industries. The network of private and public enterprises with which Norges Bank has continuous contact report little spare capacity in most industries and regions, and labour shortages in almost all occupational categories. There are shortages of drivers, pre-school teachers, supervisors, engineers, carpenters, architects, auditors, accountants, IT personnel and health workers. In some regions, enterprises report that the number of vacancies is now higher than the number of job-seekers. There are also reports of shortages of other factor inputs. It has probably not been since the 1970s that we find such widespread reports of purely physical production constraints, for example now in the form of shortages of rigs and other equipment in the petroleum industry or shortages of plank, concrete, insulation and scaffolding in the construction industry. There are also long delivery times for capital equipment such as industrial machinery and road haulage vehicles.

[2] The analysis is based on national accounts figures. There is considerable uncertainty associated with the variable real capital in this statistics.

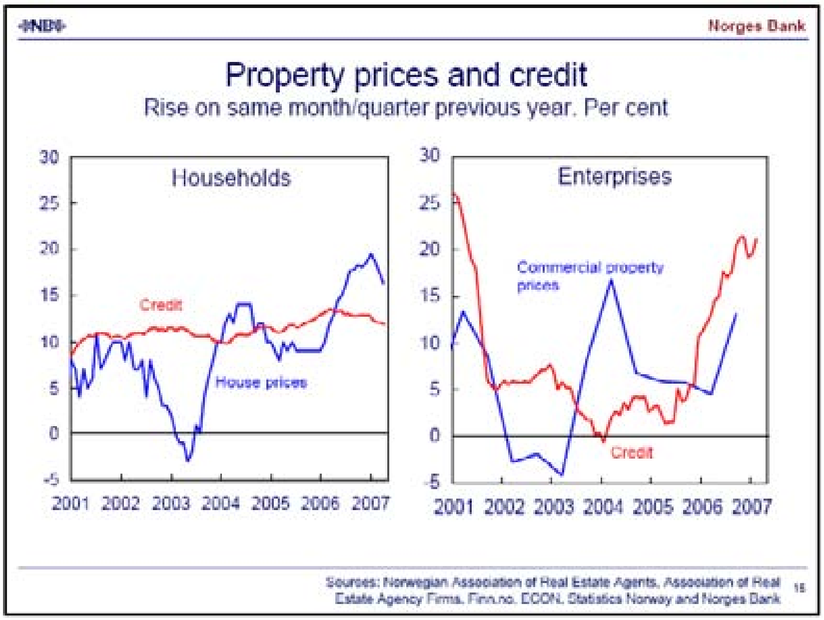
When so many enterprises are faced with capacity constraints, we can probably expect higher inflation. A rising number of enterprises in our regional network expect a faster rise in selling prices ahead. It is still uncertain whether inflation will increase rapidly or whether it will only gradually near the target of 2½ per cent.



Unemployment has fallen sharply in the past few quarters. The rate of decline and level of unemployment are reminiscent of two previous cyclical peaks, the one in the mid-1980s and the other that started in the late-1990s and continued into this decade. Both expansions culminated in a sharp rise in wage and cost inflation.



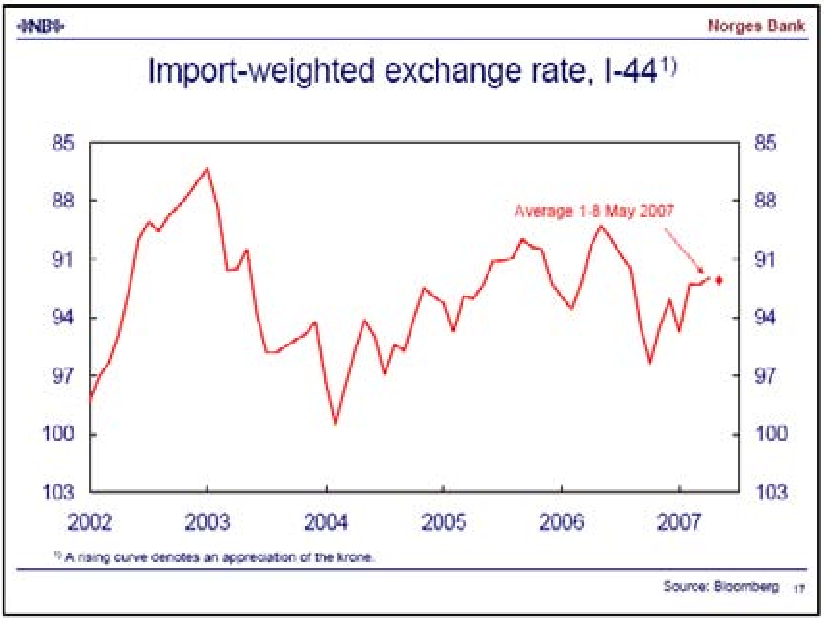
While a high level of net inward migration has increased the supply of labour, there have also been large flows out of the labour market into various benefit schemes. Sickness absence is at a high level and a rising share of the working-age population is on disability benefit or rehabilitation schemes. Many choose to retire under contractual early retirement schemes at the age of 62, and these numbers will probably increase in the coming years. In Norway, close to 600 000 persons among the working-age population are on benefit and retirement schemes. This accounts for 25 per cent of the labour force.



It may seem that household saving has fallen markedly in Norway in recent periods. Saving was negative in the latter half of 2006, and probably during the first quarter of 2007, for the first time since the mid-1980s. Housing investment in the household sector as a whole is thereby fully debt-financed. A favourable economic climate and government surpluses may have created a sense of security that is influencing household saving. The low level of saving also reflects a higher risk-willingness among households.

Household debt in Norway is now almost twice as high as disposable income, and the debt to income ratio is higher than ever. The increase in household debt has occurred in tandem with a surge in house prices.

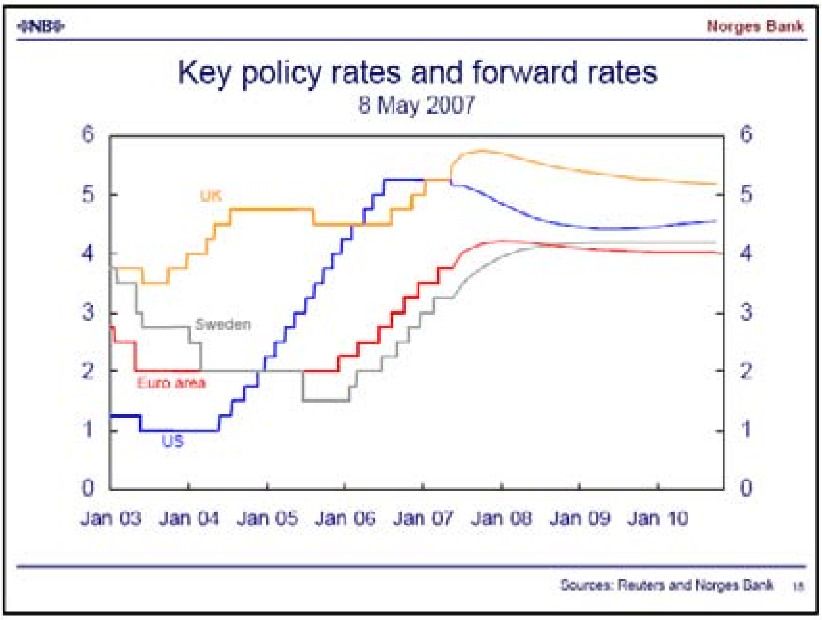
Non-residential property prices have also increased over the past years. There is now strong growth in credit to enterprises. At the same time, enterprises are rapidly building up their liquid assets.



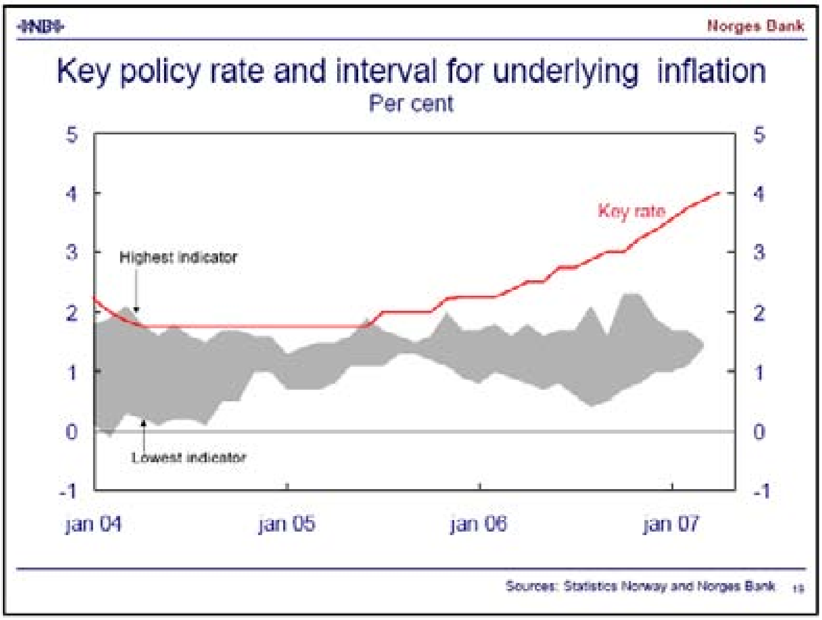
In the assessment of monetary policy, potential effects of asset prices, such as property prices and equity prices, but also of movements in the krone exchange rate, on the prospects for output, employment and inflation are taken into account.

The krone exchange rate depreciated in the latter half of 2006, but has appreciated somewhat in 2007.

Under an inflation targeting regime, it is important to be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low. Interest rate developments in other countries are therefore of importance for interest rates in Norway.



Early in this decade, inflation and economic growth were low in many countries. Interest rates were cut. The rate cuts, in conjunction with strong growth in emerging economies, particularly in Asia, led to cyclical turnaround. Growth in the world economy is now the strongest witnessed in several decades. External interest rates have increased and are approaching a normal level. Further interest rate hikes are expected in the euro area, Sweden and the UK, while interest rates in the US may fall over the next year.

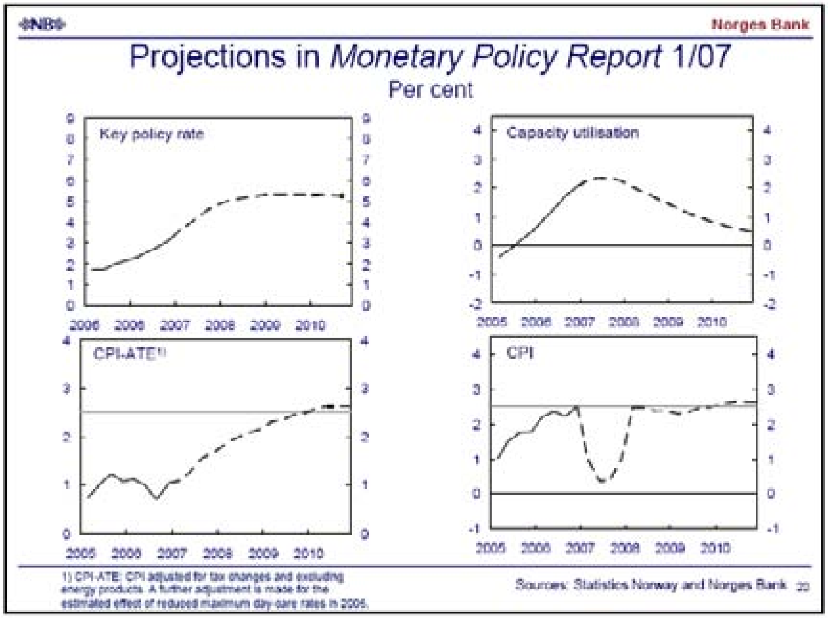


In Norway, the interest rate was reduced to a very low level in 2003 and 2004 when inflation fell and approached zero. There is a dynamic inherent in interest-rate setting. Low interest rates stimulated demand and production and eventually led to prospects for higher inflation, to which we are reacting by raising interest rates.

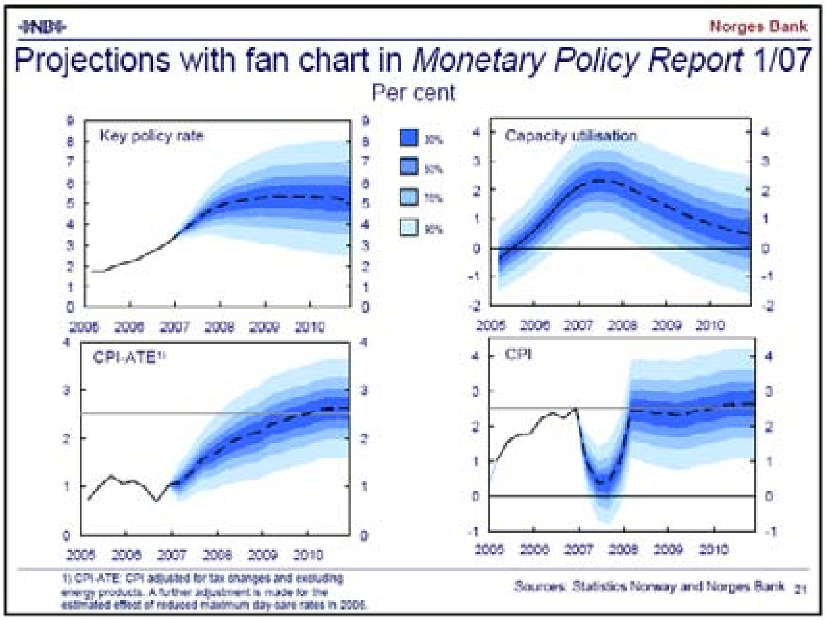
Interest rate developments must be seen in the light of actual price developments and inflation, output and employment prospects.

It normally takes some time for interest rates to have an impact on prices via changes in expectations, exchange rates or capacity utilisation. Consequently, interest rate setting must be based on our expectations of developments ahead. The interest rate was raised in response to the strong increase in capacity utilisation and the associated inflation prospects. The interest rate has thus been increased well ahead of an actual rise in inflation.

Growth in capacity utilisation has been stronger than projected one year ago. The interest rate has thus been increased somewhat faster than Norges Bank presented as the most likely path at that time.



In the interest of enhancing the transparency surrounding our conduct of monetary policy, we have published our own interest rate forecast over the past year and a half. According to the latest assessments of the Executive Board, the overall outlook suggests that it would be appropriate to raise the interest rate gradually to about 5 per cent in the course of this year and to a somewhat higher level in the period to summer 2008. At its meeting on 25 April, Norges Bank's Executive Board decided to leave the key rate unchanged at 4.00 per cent. The Executive Board considered the alternative of increasing the interest rate at that meeting.



There is obviously considerable uncertainty surrounding the projections. The projections are based on our assessment of today's economic situation, the outlook for developments in other countries, the functioning of the economy and the conditions necessary for reaching the inflation target. The chart shows that we must be prepared for developments in inflation and output that may differ from the central path. This may also imply that the interest rate may be lower or higher than our current projections.

Allow me to summarise:

The fall in prices for imported goods and services and the increase in export prices have provided the Norwegian economy with an appreciable income boost. The mainland economy has expanded rapidly in recent years. At the same time, inflation has remained low. Increased efficiency and an ample supply of labour have made a contribution to these developments. There are now limited idle resources.

Monetary policy increasingly reflects that many Norwegian enterprises are facing capacity constraints and that inflation will pick up. Interest rates will continue to be raised gradually ahead so that we can assess the effects of interest rate changes and other new information about economic developments.

Thank you for the opportunity to present these assessments before answering questions.