Mr Gjedrem considers challenges to economic policy in Norway

Address by the Governor of the Central Bank of Norway, Mr Svein Gjedrem, at Gausdal on 28/1/99.

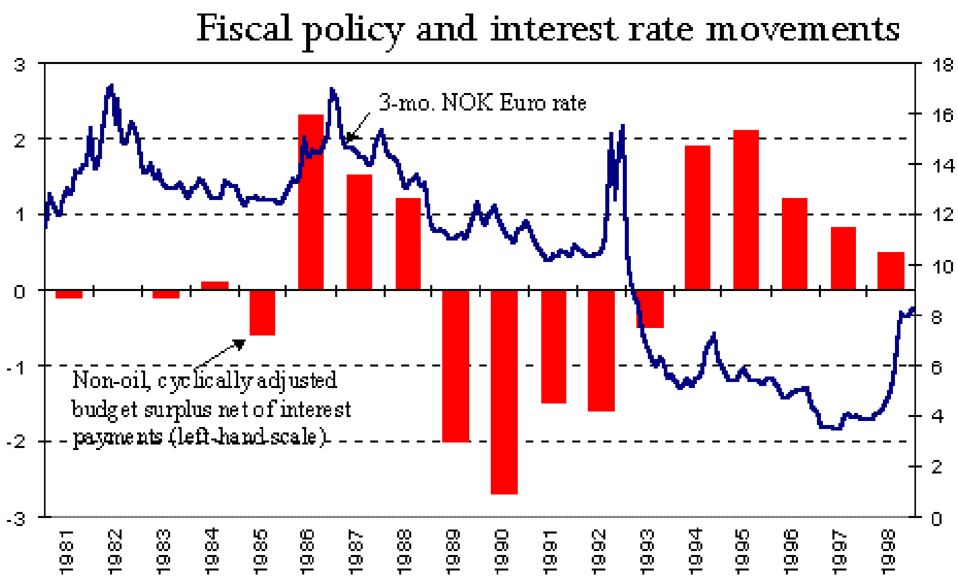
1) Economic policy in Norway

In Norway, fiscal policy has been an important economic policy component for stabilising the demand for goods and services. Since 1994, monetary and exchange rate policy have been oriented towards maintaining a stable exchange rate against European currencies. The social partners are responsible for negotiating wages and thereby have a substantial influence on employment.

From 1986 to December 1992, Norway operated a fixed exchange rate regime. The fixed exchange rate policy introduced in the summer of 1986 served as a nominal anchor for economic policy, and inflation was gradually brought under control. This process was associated with considerable real economic costs in the form of idle production capacity in the period 1988-1992. However, the cost of stabilising the economy was hardly greater in Norway than in countries experiencing a comparable situation. On the contrary, Norway avoided the sustained increase in structural unemployment and the persistent deterioration in government finances experienced by many European countries in the 1980s and 1990s, and which they are carrying with them into the next decade. Norway's policy laid the foundation for balanced and broad-based economic growth in the years after 1992.

Following the decision to allow the krone to float on 10 December 1992, the guidelines for monetary policy were revised. Monetary policy was subsequently oriented towards exchange rate stability, but without stipulating a central rate with fluctuation margins. This was formalised in guidelines set out in the Exchange Rate Regulation laid down by Royal Decree of 6 May 1994.

If stabilisation policy is to have the intended effect, all components of policy must function effectively. This has not been the case in the last three years.



Sources: The Ministry of Finance and Norges Bank
1) Change from previous year. Per cent of mainland GDP.

For several years, average annual growth rates and employment growth have been markedly higher in Norway than the average for the rest of Europe. In part fuelled by the sharp expansion in petroleum investment, pressures built up in the economy, accompanied by growing labour shortages.

Following the currency crisis in autumn 1992, Norwegian interest rates rapidly fell to European levels. The interest rate level in Europe fell after the turmoil early in the 1990s. As growth gradually picked up in Norway, the economy was stabilised by tightening fiscal policy. In order to stabilise the krone exchange rate, Norges Bank reduced its key rates at the beginning of 1997 after the krone had appreciated markedly over a period.

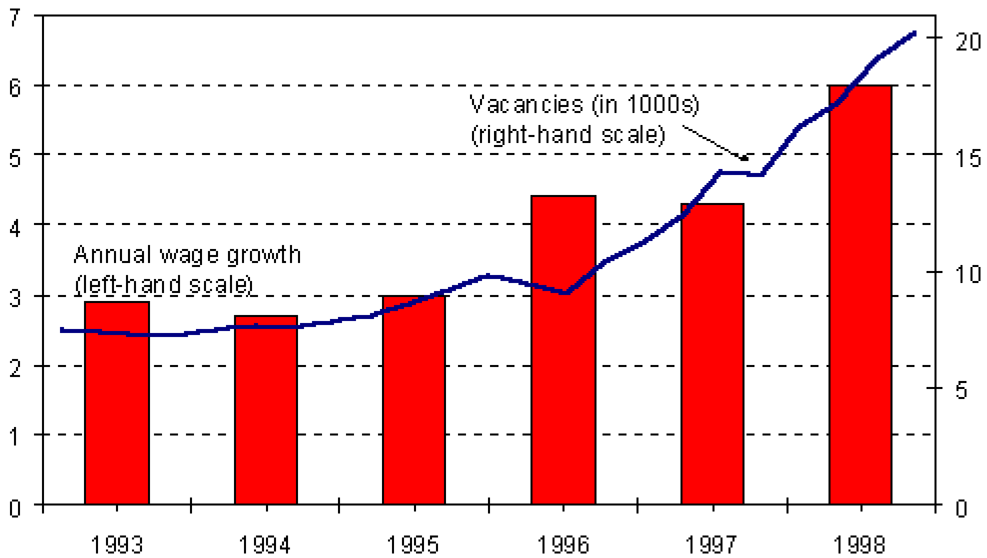
Fiscal policy is an important instrument for smoothing fluctuations in the economy. However, it has proved difficult to prevent fiscal policy from being influenced by mood shifts that occur when the economy approaches a peak and memories of earlier recessions fade. Monetary policy shall provide a nominal anchor for economic developments. With exchange rate stability as the anchor, monetary policy may be pro-cyclical in periods. This may give rise to considerable challenges in terms of the Government’s and the Storting’s (Norwegian parliament) ability and will to maintain a firm fiscal stance. Under a system designed to maintain exchange rate stability, it is important that the authorities actually manage to implement fiscal policy in such a way that pronounced and undesirable cyclical fluctuations do not occur.

During the last cyclical upturn, fiscal policy has been relatively tight, but the tightening element became weaker as growth gained momentum. Fiscal policy should have been tighter in 1996, 1997 and 1998. Another lesson from this period is that investment in the petroleum sector should be managed better in order to avoid fluctuations in the mainland economy. One cannot expect the central government budget to be able to counter the shocks to the mainland economy originating from the wide fluctuations in demand from oil companies.

2) Internal instability

Fiscal policy has not had a sufficient stabilising effect on the economy in recent years. This has given rise to a dilemma for the social partners involved in the income settlements.

Labour market - changes in annual wages and vacancies



Sources: Directorate of Labour and Norges Bank

Moderate wage settlements made a substantial contribution to achieving broad-based employment growth from 1992. In the period 1993-1998, employment rose by more than 250 000, while unemployment fell from about 6.5 per cent to below 3 per cent, the lowest rate recorded for 10 years. Whereas 20 unemployed were competing for each vacancy at the employment offices in 1993, the ratio was reduced to a little more than 2 in 1998.

An increasingly tight labour market has led to rising wage growth. Last year's wage settlements resulted in nominal wage growth of 6 per cent in 1998. Evidence suggests that wages in Norway rose by more than 71/2 per cent between the fourth quarter of 1997 and the fourth quarter of 1998. In the local government sector, wage growth is set to top 9 per cent at the end of the year. As pay increases became effective late in the year, the wage carry-over into 1999 (3-31/2 per cent) will be substantial. Assuming normal wage drift - roughly 1-11/2 per cent - and moderate negotiated pay increases, wage growth may easily near 6 per cent this year. Even if no negotiated pay increases are awarded, wage growth is not likely to be lower than 41/2-5 per cent in 1999 as a result of the substantial wage carry-over. The wide wage growth differential against other countries will continue. Wage growth in the euro area was about 1.7 per cent last year, and wage growth is expected to be about 21/2 per cent this year. A wage settlement with no increase in wages in Norway will, however, contribute to curbing annualised wage growth by a substantial margin in the course of the year.

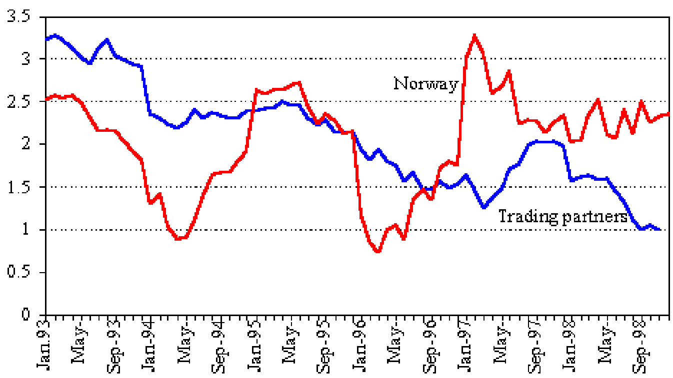
With sizeable labour shortages, a short-term interest of both employers and employees is high wage increases, with high wage growth as a result. However, the economy has built-in stabilisers. High wage growth will reduce employment and thereby the risk of persistently high wage growth.

3) Wider inflation differential against trading partners

The Asian crisis has resulted in reduced international consumer price inflation.

General pressures in the economy have had only a marginal impact on price inflation in Norway. Consumer price inflation hovered around 2.5 per cent throughout 1998, which was well below the level anticipated by most observers. The fall in import prices has been the main factor restraining the rise in prices. The Asian crisis has probably had a dampening impact on international price inflation. The direct effect of the crisis has been a fall in the prices of goods produced in Asian countries and the indirect effect has been a slowdown in global demand and intensified price competition across countries. As a result, commodity and producer prices have also fallen. The widening of the inflation differential projected by Norges Bank has occurred as result of reduced inflation in other countries.

12-month rise in consumer prices



Sources: OECD and Norges Bank

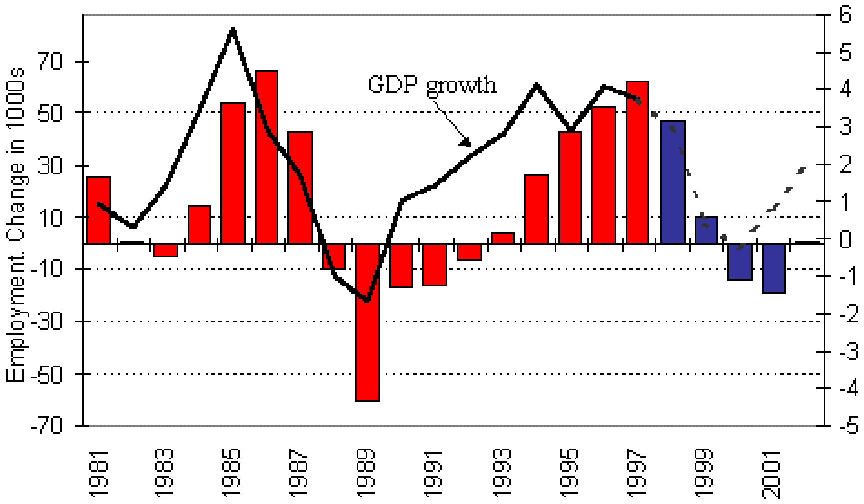
Wide sectoral differences in price developments

Although inflation has remained stable in Norway, there are wide differences in price developments among various sectors. Services prices have shown the sharpest rise, moving up by as much as 7 per cent in 1998. The main explanatory factor is that the high level of wage growth has a greater impact on this sector as labour costs account for a substantial share of total costs. The rise in the consumer price index is being restrained by subdued or zero import price inflation.

4) The Norwegian economy at a turning point

The Norwegian economy continued to expand at a relatively strong pace in 1998, albeit somewhat more moderately than in previous years. In Norges Bank's December Inflation Report, the central bank projected a period of slower growth. Several years of robust growth have contributed to high capacity utilisation. Labour shortages and high wage growth will have a dampening impact on growth in the years ahead.

GDP growth rates and employment growth



Sources: Statistics Norway and Norges Bank

Forecasting is a challenging enterprise at a stage when the economy is nearing a turnaround. It is difficult to pinpoint the timing and the amplitude of the turnaround. However, evidence now suggests that Norway is entering a period of slightly weaker growth. The international environment has led to slower growth in demand and lower prices on the world market. This is weakening profitability in the export sector in Norway. In addition, the wage settlements have increased business costs, which will increase the need for enhancing the efficiency of enterprises. Reduced earnings and higher interest rates will have a dampening effect on business investment. The extraordinarily high level of oil investment recorded in recent years has been expected to fall for some time. The drop in oil prices may lead to more pronounced cyclical fluctuations. Restructuring, streamlining and cost cuts in the oil industry will also affect employment.

The local government sector, where employment has increased sharply during this cyclical upturn, placed itself in a very difficult situation during the last income settlement. It now has to consolidate its financial position and employment growth in this sector is expected to show a marked slowdown.

There are already signs of a turnaround in the labour market. Unemployment is no longer falling and is expected to rise in the period ahead. The labour market is still tight, and Norges Bank projects weak growth in employment in 1999. The labour market will be just as tight during this year's wage negotiations as it was last year, but the outlook for employment is now less favourable. Employment may fall somewhat from next year. Unemployment was projected to rise to about 41/2 per cent in 2000 in the December Inflation Report.

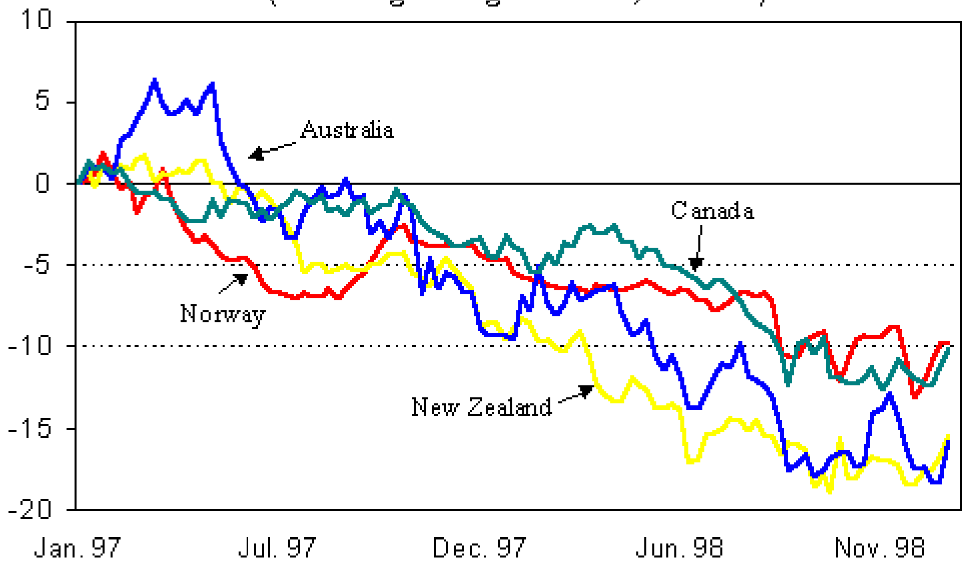
Norges Bank's projections indicate that the turnaround will not be as pronounced as the situation at the end of the 1980s, partly owing to the fact that households and enterprises are much better equipped to cope with a downturn today than at the end of the 1980s. The financial position of households is much stronger. The enterprise sector is more solid, and the banks' core capital ratios are substantially higher. Price and wage inflation was much more out of step with the situation in 1986 and 1987, with double-digit inflation.

I am not saying this to trivialise the challenges at hand. It is always a challenge to formulate economic policy when faced with such a substantial decline in income alongside imbalances in the labour market. Developments in the 1970s and 1980s showed that a higher rise in costs in Norway relative to other countries leads to a slacker labour market. This will also be the case this time.

5) Pressures on the exchange rate of commodity-based economies

There is a correlation between price inflation and the exchange rate. As mentioned, the exchange rate has a significant influence on prices and costs through its effect on import prices. Furthermore, a precondition for maintaining a stable exchange rate against European countries is that inflation in Norway is over time on a par with the inflation rate prevailing in these countries. The high rise in costs in 1998 was probably the main factor that weakened confidence in the krone.

Trade-weighted exchange rates in commodity-based countries
(Percentage change from 15 Jan. 1997)



Source: Datastream

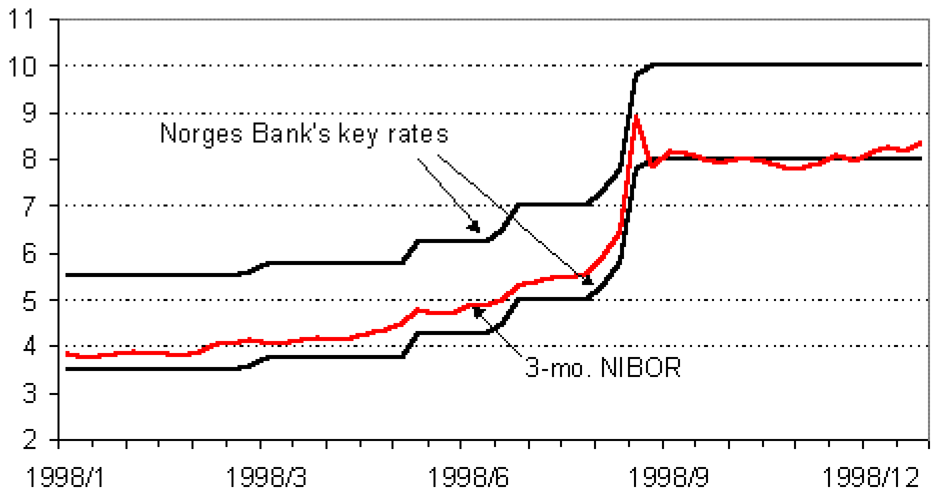
International conditions also played a significant part. In 1998, the world economy was hit by the financial crisis in Asia, Russia and Brazil, falling commodity prices and widespread unrest in international financial markets. The Asian crisis proved to be more serious and prolonged than envisaged, and the contagion effects were more severe than most observers had anticipated. Weaker global demand contributed to a sharp fall in commodity prices, which in turn had a severe impact on commodity-based economies such as Norway, Canada, New Zealand and Australia. For all these countries, the terms of trade worsened and exchange rates depreciated.

The Asian crisis also made investors more cautious, with an outflow of investment from countries perceived as risky. After it became clear that Russia would not, in practice, be servicing its foreign debt, market participants became highly risk-averse. The unrest spread to European financial markets and Norway. Investors fled to safe-haven countries such as Germany, the US and Switzerland, and the currencies of countries with less liquid and more volatile financial markets depreciated. This included countries such as Norway and Sweden. The Norwegian krone depreciated sharply from around 101 against the ECU index at the beginning of the year to 115 in October, or the weakest rate since the objective of exchange rate stability against the ECU was adopted.

6) Monetary policy in 1998

Norges Bank responded to the sharp depreciation of the krone by raising its key rates in several steps in 1998. These rates were first raised in March, after the krone weakened in the first three months of the year from 101 to about 103.5 against the ECU index. The krone then appreciated slightly and stabilised for a period. Pressure on the krone increased during the summer. Norges Bank responded by raising its key rates on six further occasions. Following the last increase on 25 August, the deposit rate and the overnight lending rate were 8 and 10 per cent, respectively, i.e. 4.5 percentage points higher than at the beginning of 1998.

Interest rate movements in 1998



Source: Norges Bank

It is difficult to predict the direct short-term effect of changes in interest rates on the exchange rate. It is particularly difficult in instances where fluctuations in the exchange rate are amplified as a result of speculation, hedging and portfolio shifts in financial markets.

7) The Exchange Rate Regulation

Norges Bank's use of instruments in 1998 was in keeping with the Exchange Rate Regulation of 6 May 1994:

"Section 1

The international value of the Norwegian krone is determined on the basis of exchange rates in the foreign exchange market.

Section 2

The monetary policy to be conducted by Norges Bank shall be aimed at maintaining a stable krone exchange rate against European currencies, based on the range of the exchange rate maintained since the krone was floated on 10 December 1992. In the event of significant changes in the exchange rate, monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range. No fluctuation margins are established, nor is there an appurtenant obligation on Norges Bank to intervene in the foreign exchange market.” (My underlining)

Pursuant to these guidelines, Norges Bank raised the deposit and overnight lending rate by 1 percentage point on 25 August. In connection with the increase in interest rates the Bank stated that instruments were subsequently to be oriented “with a view to returning the exchange rate over time to its initial range”. In the opinion of Norges Bank, the situation in the financial market was such that it would not be appropriate to make further use of its instruments. The substantial pressure on the krone towards the end of October hardly reflected economic fundamentals in Norway.

8) Interventions

Exchange-market interventions are an important instrument of monetary and exchange rate policy. Norges Bank intervened to support the krone for the equivalent of NOK 29 billion in the period from mid-October to mid-December. Unrest in international financial markets in the wake of the financial crisis in Russia intensified the speculative pressure on the krone. It is the Bank’s view that this speculation was not justified by economic fundamentals in Norway. It was therefore necessary to defend the krone through interventions in order to prevent a self-reinforcing and unnecessary weakening of the krone.

Norges Bank will continue to consider using interventions if market conditions so warrant. For example, a central bank may have to intervene directly in order to stabilise the market, particularly if international turbulence leads to panic-like market reactions.

From a somewhat longer-term perspective, the experience of large-scale and persistent interventions is mixed. When the central bank intervenes heavily to defend the krone, market participants may easily move into a game situation and perceive central bank intervention as an interesting opportunity to make a profit. Market operators know that a situation in which the krone is perceived as “artificially strong” because Norges Bank is buying kroner cannot persist. It is then tempting to take reverse positions in the foreign exchange market in relation to the central bank. This means that heavy and prolonged interventions may be self-reinforcing over time, steadily increasing the necessary volume of intervention purchases required to maintain the krone exchange rate.

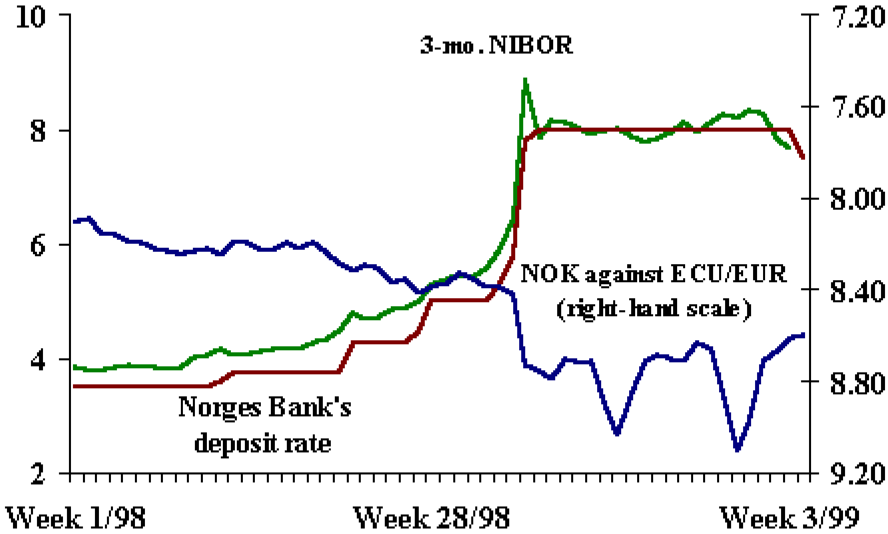
The foremost example of such a game situation in Norway’s exchange rate policy history was Friday, 20 November 1992, when we made intervention purchases for NOK 37 billion from the time the market opened until the market closed.

Norges Bank does not want to intervene in such a way that this type of game situation arises. However, the Bank will use interventions if the krone moves substantially out of line with what we consider to be reasonable based on fundamentals or in the event of exceptional short-term volatility. It may also be appropriate to reinforce a desired development in the exchange rate that has already been observed in the market. In such a situation, it is assumed that the risk of ending up in a game situation against exchange market players is marginal. However, we must take into account that the krone exchange rate cannot in the long run deviate substantially from the level implied by economic fundamentals.

The instrument available to Norges Bank for influencing economic fundamentals is the interest rate. Over time, therefore, the interest rate is the most important instrument of monetary and exchange rate policy. This is also recognised in the formulation of the guidelines for monetary policy. According to the National Budget for 1999, “Interest rates must be adjusted in order to avoid persistent and large-scale interventions”.

9) Formulation of monetary policy

Norges Bank reduced its key rates by 0.5 percentage points effective from today. This decision came in response to developments in money and foreign exchange markets and the prospect of reduced pressures in the real economy.



The outlook for the Norwegian economy has changed since Norges Bank raised its key rates in August. The forecasts for growth in the world economy have been revised downwards and persistently low oil prices have reduced demand in the oil sector. In addition, a tight government budget for 1999 and the high interest rate level are having a restraining effect on growth. At the same time, the krone has appreciated recently. This lays the foundation for slower price and wage inflation in the years ahead, as estimated by Norges Bank in its December Inflation Report. Developments in recent weeks have confirmed this picture, providing room for a slight reduction in interest rates.

According to the Exchange Rate Regulation, “... in the event of significant changes in the exchange rate, monetary policy instruments shall be oriented with a view to returning the exchange rate over time to its initial range”. The guidelines provide considerable scope for discretion in the conduct of monetary policy. It is Norges Bank’s task to exercise this discretion.

Interest rates are set with a view to returning the krone exchange rate over time to its initial range. Even with this interest rate reduction, the interest rate differential against European countries is substantial.

A precondition for maintaining a stable exchange rate against the euro is that price and wage inflation is on a par with that of euro countries over time. When the krone exchange rate is weak, Norges Bank therefore sets the interest rate with a view to low price inflation. At the same time, we must avoid a situation whereby interest rates are so high that monetary policy contributes to a downturn that undermines confidence in the krone. Interest rates are set based on these considerations.

This is not a new policy. In an address to the annual general meeting of Forex Norge in August last year, Kjell Storvik stated:

“I would point to the well-known fact that a lower krone exchange rate may contribute to fuelling inflation expectations and that such expectations may in turn generate expectations of a weakening of the krone exchange rate, thereby reinforcing depreciation pressures. Price expectations may thus prove to be a self-fulfilling prophecy. The interest rate level which has now been established should, in addition to directly contributing to stabilising the krone exchange rate, also limit price expectations...”

I should also like to quote the following from the Revised National Budget for 1994:

“A stable exchange rate can generate expectations of continued low inflation, which in turn influence both price and wage determination. Moderate price and wage inflation is also a necessary condition for a stable exchange rate over time.”

A prerequisite for the conduct of monetary policy is that fiscal policy generally contributes to stable economic developments. Fiscal policy influences the total level of domestic activity, and thereby the rise in the prices and costs of goods and services produced in Norway. In a situation with a high level of economic activity, an expansionary fiscal policy will tend to push up price and wage inflation. This in turn will influence expectations in the foreign exchange market concerning future movements in the exchange rate, fuelling depreciation pressures and therefore impeding the implementation of monetary policy. A fiscal policy adapted to the economic situation, on the other hand, will contribute to facilitating the implementation of monetary policy.

In the current economic situation, the pressure in the economy should be dampened. The tightening in the National Budget for 1999 of 3/4 per cent of GDP will help to curb price and wage inflation and alleviate the pressure on monetary policy.

10) Conclusion

We are thus facing a period of slower growth. Given the pressure that has built up in the economy, particularly in the labour market, such a correction is inevitable as a result of production constraints. However, the prospects are much brighter than after the fall in oil prices and the wage settlement in 1986. The Norwegian economy – including both households and the business sector – is now in a stronger position to cope with a cyclical turnaround. A few years of slower growth will also have a favourable effect on price and wage inflation in Norway, and thereby on the more long-term growth capacity of the economy. Norges Bank’s projections indicate that price and wage inflation could drop to the level of our trading partners after the turn of the millennium. Lower domestic demand will also contribute to curbing the strong import growth recorded in recent years, thus improving the current account.

As mentioned, forecasting is a challenging task when the economy is on the verge of a turnaround. It is not easy to predict the exact timing of the turnaround. It will be difficult to avoid some adjustment through a slackening in the labour market. Even if there are already signs of some slackening, we must bear in mind that the market is still very tight. A moderate wage settlement this spring – with the social partners taking future developments into account – may contribute to maintaining the level of employment.

Monetary policy instruments are oriented with a view to returning the krone exchange rate over time to its initial range. The guidelines provide considerable scope for discretion in the conduct of monetary policy. It is Norges Bank’s task to exercise this discretion. A precondition for maintaining a stable exchange rate against the euro is that price and wage inflation is on a par with that of euro countries over time. When the krone exchange rate is weak, Norges Bank therefore sets the interest rate with a view to low price inflation. At the same time, we must avoid a situation whereby interest rates are so high that monetary policy contributes to a downturn that undermines confidence in the krone. Interest rates are set based on these considerations.

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