Svein Gjedrem: Monetary policy and the outlook for the Norwegian economy

Address by Mr Svein Gjedrem, Governor of the Norges Bank, at a meeting of Sparebanken Nord-Norge, Tromsø, 25 September 2001.

Please note that the text below may differ slightly from the actual presentation Summary and charts.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 19 September.

*   *   *

Norway's economic policy is based on new guidelines for fiscal and monetary policy. The new guidelines were published by the Government on 29 March 2001 in connection with the presentation of the Government's Long-Term Programme. The inflation target for monetary policy came into force immediately. The guidelines for fiscal policy were discussed in the Storting in June and were approved by a majority.

Monetary policy is oriented towards low and stable inflation. The inflation target is set at 2½ per cent. 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 the 1990s, monetary policy gradually moved further away from the fixed-exchange-rate regime which was practiced from 1986 to 1992.

Low and stable inflation is the best contribution monetary policy can make to growth, prosperity and income distribution. In the long term, monetary policy has little effect on the real economy.

Low and stable inflation can, however, provide fertile ground for stability and growth. It reduces the possibility of unsound investments and bubbles in the financial and property markets. Nominal stability will also reduce the risk of sudden changes and shocks that may lead to cyclical turnarounds.

Historically, economic growth has generally been strong in periods with relatively low inflation and weak during periods with especially high inflation. Hence, during the last 20 years, real wage growth, which over time reflects productivity trends, has been strongest when inflation was low. In the 1980s, nominal wage growth was strong without a basis for this in the real economy. The result was inflation and weak real wage growth. In the 1990s, more moderate nominal wage increases until 1998 coincided with strong real wage growth because inflation was low.

It takes considerable time before monetary policy has an impact. The effects of interest rate changes are uncertain. The key rate is set on the basis of an overall assessment of the inflation outlook. 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. 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 expression "it appears that" refers to our best estimate of inflation two years ahead. Norges Bank publishes its inflation projections in the Inflation Report three times a year (every four months). The Inflation Reports include both a point estimate and an uncertainty interval around the projection. In the most recent Inflation Report which was published in June, we believed that there was approximately a 75 per cent chance that inflation would be between 2 and 3 per cent in 2003. We also believed that the probability that inflation would be higher than 2 ½ per cent was about the same as the probability that it would be lower than 2 ½ per cent.

Growth forecasts for the global economy this year have been lowered substantially. Earlier, a decline in some regions has often been counteracted by an upswing in other regions. The changes now appear to be more concurrent than in 1975, 1982 and 1991. The summer months have brought a great deal of bad news from the global community. After the tragic events on 11 September, the uncertainty is even greater than before.

Industrial output is declining markedly in all major regions in the world economy. The situation has shifted rapidly in the US, following strong growth throughout most of the 1990s.

The contagion effect from the US to Europe has been more pronounced than expected. Channels other than trade have probably had a greater impact than expected. Expectations can be affected quickly. High correlation between share prices in different countries may be an important carrier of contagion. Enterprises with worldwide operations may be another. The economic indicators show a clear slowdown in growth in Europe's industrial output.

The effect on the Swedish economy has been severe, resulting in a record-low exchange rate. One Swedish krone now costs approximately 80 Norwegian øre. This is 30 per cent less than 10 years ago.

Vulnerable emerging economies with high government debt must pay very high interest rates to borrow capital.

Many central banks have reduced interest rates, most recently 17 and 18 September. Interest rates have been reduced because of the prospect of a downturn in each of these economies. Real interest rates are low in many countries.

The inflation component that is driven by domestic wage and price increases is still high. Growth in Norwegian labour costs has been around 5-6 per cent in recent years. This is 1½ - 2 percentage points higher than among our trading partners. The higher interest rate level in Norway reflects this fact. At the moment, there is no clear indication of a marked slowdown in the Norwegian economy.

The price of oil remained high for a long time, despite the international downturn, but fell more than USD 3 yesterday, 24 September. The price of aluminium has fallen somewhat but is still high compared with the average price in recent years. The year-on-year increase in the export of metals, excluding iron and steel, was 0.7 per cent in the second quarter of 2001. The price of fresh salmon remains at the same level as in the last half of the 1990s. Exports of fish and fish products increased by 3.9 per cent from the second quarter of 2000 to the second quarter of 2001. Due to international developments, the uncertainties and the downside risks are now greater for many export industries.

The krone has appreciated recently measured against our trading partners (trade-weighted exchange rate index). This partly reflects more than 20 per cent appreciation against the Swedish krone since spring 2000. Measured by the trade-weighted exchange rate index, the krone is now about 2 per cent weaker than in 1990 and on a par with the level in 1994-95.

So far this year, the volume of traditional merchandise exports have increased more than in the same period last year, but growth is levelling off. The exposure of Norwegian exports in the ICT sector, where the international downturn has been most severe, is limited. Norway's manufacturing output has declined somewhat this year, but less than in other countries. On the other hand, Norwegian manufacturing industry did not experience the upswing in 1999 and 2000. The business sentiment indicator does not suggest a severe decline. The order situation is still satisfactory in many industries. This does not necessarily mean that the turnaround will not occur in Norway as well. A sharp fall in share prices, tighter borrowing terms and an imbalance in international credit markets may quickly affect investment, prices, profitability and expectations. So far, however, it is difficult to draw any conclusions except that uncertainty has increased.

The Norwegian economy is operating at capacity limits and there are few if any available resources in the labour market. Unemployment has declined throughout the country. Unemployment in Western Norway, which increased marginally last year, has returned to its previous level. Unemployment has risen slightly again in Eastern Norway. This reflects lower employment in private services that may be a result of a slight downturn in the ICT industries and retail trade.

The Government's Long-Term programme for 2002-2005, which was approved by the Storting in June 2001, states: "Considerable emphasis must be placed on stabilising fluctuations in the economy in order to ensure appropriate capacity utilisation and low unemployment. Petroleum revenues will gradually be phased into the economy, approximately in step with the expected real return of the Petroleum Fund."

Fiscal policy will contribute to stimulating activity in the economy because of the increase in spending of oil revenues. The new guidelines imply that the non-oil deficit will increase in the years ahead. This will provide a substantial fiscal stimulus every year.

Summary

The tragic events in the US on 11 September will contribute to a further dampening of activity in the American, Asian and European economies. It is too early to predict the long-term effects. Reactions in financial markets have been pronounced. Share prices have fallen sharply. The U.S. dollar has depreciated. Currencies of other economies such as Sweden have depreciated.

Central banks have ensured the smooth functioning of markets by supplying liquidity to the banking system. Interest rates have been cut in the US, Canada, the euro area, Switzerland, Sweden, Hong Kong, Taiwan, Denmark, Japan, the UK, New Zealand, Korea and Malaysia. These cuts will contribute to mitigating the negative effects on demand, output and employment.

The Norwegian economy is characterised by high capacity utilisation and strong cost inflation. The mainland economy appears to be expanding approximately in line with growth in output potential. At present, we do not have sufficient evidence to assert that international developments will change this situation. The announced increase in spending of petroleum revenues may lead to a more expansionary fiscal stance than in recent years. According to Norges Bank's assessment, with an unchanged interest rate ahead, the probability that inflation two years ahead will be higher than 2½ per cent is the same as the probability that it will be lower.