Svein Gjedrem: Monetary policy and the economic outlook

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at SR-banken, Stavanger, 19 March 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 11 March, Inflation Report 1/04 and on previous speeches.

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

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The operational target of monetary policy as defined by the Government is inflation of close to 2.5 per cent over time. The target is symmetrical - it is just as important to avoid an inflation rate that is too low as an inflation rate that is too high. The inflation target provides economic agents with an anchor for inflation expectations. It therefore influences their decisions concerning saving, investment, budgets and wages. History shows that there is no long-term trade-off between lower unemployment or stronger economic growth and higher inflation. We witnessed this in the 1980s when growth was low and inflation high. The task of monetary policy is to provide a nominal anchor. Low and stable inflation is such an anchor.

There are several reasons why it is an advantage for inflation to be higher than zero:

- The structure of the economy is in flux. Demand for labour with different qualifications is changing. This requires changes in relative wages. There are rigidities in nominal wage growth. Nominal wages do not readily fall. With some inflation, relative wages can change without a fall in nominal wages. There may also be rigidities in the pricing of goods and services. Some degree of inflation will thus oil the economic machinery.
- In periods, inflation and economic growth will be low. It is then appropriate for real interest rates to be low, or even negative. Nominal interest rates cannot be set below zero. If inflation becomes entrenched at a low level or near zero, the interest rate will be less effective as an instrument.
- There are different ways of measuring inflation. The consumer price index tends to overestimate actual inflation. The most important source of measurement errors is probably the difficulty of distinguishing between changes in the quality and price of goods. In other countries, findings show that the consumer price index overestimates actual inflation to the order of ½-1 per cent.

The inflation target is a vehicle for, not an obstacle to, monetary policy's contribution to stabilising output and employment. This objective is also expressed in the Regulation on Monetary Policy. If demand for goods and services is high and there is a shortage of labour, there will normally be prospects of higher inflation. When interest rates are increased, demand falls and inflation is kept at bay. If demand is low and unemployment rises, there will be prospects of lower inflation. The interest rate will then be lowered.

In the long run, output is determined by the supply of labour and capital and adaptability, but in the short and medium term monetary policy can also have an impact on the real economy. The economy grows over time. Output moves in waves. Output will in some periods lie below trend growth and in others above trend. The difference between trend output and actual output is called the output gap. Stabilising output growth means that one seeks to maintain actual output near trend.

The output gap provides an indication of pressures in the real economy. Developments in the output gap provide a basis for assessing output stability and can thus also shed light on domestic inflationary pressures in the economy. When the economy is booming, the output gap is positive. When the economy is at a low ebb, the output gap is negative.

We have had pronounced economic cycles in the Norwegian economy. The downturn at the beginning of the 1990s was followed by an upturn from 1993. This upturn peaked in 1998. There was a shift from a recovery to a period of strong expansion. Growth came to a halt in 2002. An upturn is now in progress.

Other indicators may also shed light on stability in output and employment. The wage gap is an indicator of the social partners' perception of employment and labour shortages. The wage gap measures the difference between actual wage growth and the growth that over time is consistent with the inflation target, and is an indicator of labour market tightness. With estimated productivity growth at 2 per cent, wage growth of 4.5 per cent over time will be consistent with an inflation target of 2.5 per cent. In the chart, the wage gap up to 2000, i.e. before the introduction of the inflation target, is defined as the difference between wage growth in Norway and in other countries. This wage gap appears to be closely in line with the output gap as measured by Norges Bank.

Normally, the interest rate is set with a view to achieving inflation of 2½% at the two-year horizon. Norges Bank operates a flexible inflation targeting regime, so that weight is given to variability in inflation as well as to variability in output and employment. Monetary policy affects the economy with a lag. The choice of a two-year horizon is thus based on striking a balance between variability in inflation and variability in output and employment, and a perception of how interest rates influence these variables. If extraordinary conditions prompt Norges Bank to apply a different time horizon than two years, the Bank will provide an assessment of this. The same applies if special emphasis is placed on developments in financial markets.

External cyclical developments and events have had considerable implications for developments in the Norwegian economy. The international upturn came to a halt in 2000. The bubbles in the equity markets burst. Many years of high investment led to excess capacity in some industries, and unemployment increased. The terrorist attacks on 11 September 2001 put a new damper on economic activity. From the summer of 2002 to the spring of 2003, a highly extraordinary accumulation of negative events in the global community - accounting scandals, fear of terror, war and disease - put a brake on growth.

US interest rates, which were sharply reduced at the beginning of the downturn, have subsequently been reduced further. Interest rates have also remained low in the euro area. Key rates are now historically very low for several of our most important trading partners. Long-term interest rates are also very low.

The economic situation in Norway remained firmer for a long period, and wage growth was surprisingly high in 2002. There was less scope for low interest rates than among our trading partners. As a result, the interest rate differential against other countries widened. This had an impact on krone exchange rate developments. In addition, special circumstances in the global economy led to a stronger krone than might have been expected from the higher interest rate differential alone. Themes in foreign exchange markets shift. In periods, investor focus on stock returns feeds through to exchange rate movements. During periods of political and economic unrest, investors may choose individual currencies as a safe haven. In the autumn of 2002, the Norwegian krone was probably also perceived as a safe haven. In the past 12-18 months, developments in the interest rate differential between Norway and other countries appear to have had a particularly marked impact on our currency. Norwegian interest rates have been pushed down towards the level prevailing abroad.

In 2003, the interest rate differential narrowed as a result of monetary policy easing. The interest rate has been reduced by 5¼ percentage points and is now approximately the same as among our trading partners. The krone has depreciated by about 6 per cent over the past year and the krone exchange rate, measured by the import-weighted index I-44, is now at the level prevailing in March 2002. This is approximately on a par with the average for the 1990s. In the past few days, the krone has appreciated again somewhat.

In February, inflation stood at –0.1 per cent. Apart from some temporary, technical factors that together account for 3-4 tenths of a percentage point, three main factors have contributed to the substantial deviation from the inflation target:

- First, the global downturn had considerable implications for the impact of interest-rate setting in Norway, via the exchange rate for instance.
- Second, low external inflation and rapid shifts in the international division of labour has resulted in a fall in prices for imported goods and services. This also applies when these prices are 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.

- Third, competition has probably increased in the retail industry and other service sectors in Norway in recent years.

Initially, heightened competition affects companies' profit margins. But enterprises will respond by reducing their costs. This will occur in part in the individual business, but subcontractors will also be required to reduce their prices and enhance efficiency.

Therefore, increased competition usually triggers higher productivity growth in the economy. Low inflation may therefore be matched by growth in productivity.

Prices for domestically produced goods and services are expected to rise towards the beginning of 2005 due to higher capacity utilisation in the Norwegian economy. Strong employment growth may contribute to somewhat higher wage growth than in 2004. At the same time, domestically produced goods and services are affected by exchange rate changes, albeit with a longer lag than is the case for imported consumer goods.

There are clear signs that the global economy has passed the trough. However, while the outlook is brighter, price inflation is still low and interest rates are being kept unusually low. Economic growth is high again in the US, but there is still excess production capacity and very low inflation. Workforce reductions may no longer be as severe, but companies are still not hiring new staff. It may take some time before interest rates are increased substantially in the US. Growth in Asia is solid, but a global rise in interest rates is unlikely to start there.

Inflation is higher in the euro area than in the US and approximately in line with the objective defined by the European Central Bank. In the euro area, however, capacity utilisation is very low, unemployment high and the outlook for growth is weaker. Recently, inflation has moderated slightly. Against this background, it will probably also take time before interest rates rise markedly in the euro area.

Interest rates abroad have been unusually low for 2½ years, and it appears they will remain low for a period ahead. This poses a challenge to monetary policy in Norway.

Growth in the Norwegian economy has picked up. Lower interest rates have contributed to sustaining growth in private consumption. Household demand will probably be the most important driving force in the Norwegian economy in the period ahead. Against the background of high real income growth, improved job security and expectations of continued low interest rates ahead, household consumption is expected to exhibit strong growth.

Petroleum investment exhibited brisk growth in 2003. Growth in petroleum investment would appear to continue in 2004, but probably at a slower rate than in 2003. Low interest rates and house price inflation imply higher housing investment in the period ahead. Fiscal policy also contributes to stimulating activity.

The impact of the interest rate decline on private consumption is likely to be stronger this year than in 2003. It takes time for changes in Norges Bank's key rate to feed through fully to interest rates for households. Norges Bank's calculations show that if we look at 2003 and 2004 as a whole, it appears that the impact of interest rate changes will result in an overall reduction of about NOK 15bn in household net interest expenses before tax. However, due to the increase in household net debt, net interest expenses will fall much less than this.

The impact of the interest rate decline is also conditioned by the expected duration of the low interest rate level. When the sight deposit rate was reduced last autumn, longer interest rates showed relatively little change. The interest rate reductions in December and January, combined with the decline in inflation, have had a stronger impact on long-term interest rates. This indicates that financial market participants expect interest rates to remain low for a longer period.

The fall in the value of the krone over the past year has strengthened Norwegian business and industry. With lower wage growth in Norway and a pick-up global activity, the prospects for Norwegian manufacturing and the business sector are brighter now than they were 12-18 months ago. The business sector is, however, still feeling the effects of a sharp rise in labour costs over a period of several years. Relative labour costs measured in a common currency are in line with the level prevailing in 1990, but approximately 10 per cent higher than in the mid-1990s. The internationally exposed sector has been scaled back. Those companies that are still operating may be in a better position to bear the high wage level.

In 2003, employment and investment both fell, although investment picked up somewhat towards the end of the year. Efficiency-enhancing measures are expected to continue to mark developments in the business sector this year. This will curb the demand for labour.

The situation varies across business sectors. Distributive trades and enterprises supplying services to households are expanding as a result of high growth in private consumption. Production for the business market fell through 2003. Demand for services in this market segment will pick up in pace with a rise in manufacturing output and other industries.

Strong competition has resulted in substantial restructuring. Manufacturing production is being moved both from Norway and other countries to lower-cost countries. This may continue. EU and EEA enlargement by 10 new members from 1 May may also increase competition in some industries, particularly in the service sector.

Investment in onshore industries in Western Norway and Northern Norway has generated a positive impetus to the construction industry. Activity in 2003 in the rest of the country has mainly been held up by public investment projects. Information from our regional network indicates that construction activity has picked up markedly in most regions. This also applies to Rogaland.

In recent year, non-residential investment has accounted for more than a third of total investment in services and distributive trades. The large investments in this sector in the latter half of the 1990s has led to a high non-residential vacancy rate. Statistics Norway’s new price index for non-residential commercial property shows that in Norway as a whole, prices peaked in the first half of 2001 and have since fallen by over 9 per cent up to the first half of 2003. This situation is likely to curb overall investment growth in the years ahead.

In 2004, many companies will probably realise the gains provided by the efficiency measures that have been implemented. Continued brisk growth in household demand is expected to boost investment activity in 2005 and 2006. Petroleum investment will also increase as a result of the Orme Lange project.

This is also the case for Rogaland. Our regional network reports that demand is on the increase, the market outlook for the next six months is favourable and corporate profitability has improved considerably. The economic upturn is primarily being reinforced and driven by stronger household demand, although without any substantial increase in investment or employment.

The upturn has both broadened out and gained momentum in the past months. All sectors report stable or increasing demand and sales. The market outlook for the next six months in this county is very positive. Optimism does not translate into a stronger willingness to invest, however. The picture for the petroleum and offshore supply industry is mixed. Operators’ production of oil and gas is high. Some sectors of the offshore supply industry experienced a difficult fourth quarter, but are more optimistic about this year. The maintenance and modification market is showing steady, although moderate, growth.

Most companies report stable employment. Extensive rationalisation and restructuring measures are still on the agenda in organisations and enterprises, and so far, growth is being absorbed by excess capacity or by increased productivity. Wholesale and retail trade and the building and construction sectors are increasing their workforces. All industries continue to report that highly qualified labour is in ample supply.

Of the Norwegian counties exporting traditional goods, Rogaland is the third largest. The public sector and some private service industries are as important for employment in Rogaland as they are in the rest of Norway, but the share of employment in these sectors is lower than the national average. Manufacturing and oil and gas production are important in Rogaland, but the internationally exposed sector is also relatively large. Employment in Rogaland is mainly concentrated in engineering, shipbuilding and construction of oil platforms. Many are also employed in the food and beverage industry, and Rogaland is an important farming county.

The labour market in Norway has improved. The number of persons employed in Norway began to increase in summer 2003 and unemployment stabilised. Employment in distributive trades has increased. There are also signs that employment is rising in education, the public sector and health and social services, from the weak levels recorded in the first six months of last year. Manufacturing employment remained well below the level one year earlier in the fourth quarter of 2003, but is falling at a slower pace. Unemployment has been fairly stable. Adjusted for seasonal variations, LFS unemployment stood at 4.6 per cent of the labour force as measured by Statistics Norway's Labour Force Survey (LFS) in the fourth quarter of 2003.

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. This year, employment growth is expected to be fairly moderate even if there is a sharp rise in output. Only a slight decrease in unemployment is projected for 2004. Unemployment is projected to edge down in 2005 and 2006.

After several years of high wage growth, pay increases in last year's settlement were more moderate. Annual wage growth was nonetheless 4½% as substantial increases with effect from 2003 were awarded in the 2002 main wage settlement. Wage growth is projected to decline to 3¾% this year. The labour market appears to be improving somewhat more rapidly than expected previously. In isolation, this may contribute to pushing up wage growth relative to previous projections. The effect is, however, expected to be more than offset by the prospects of very low inflation this year. In 2005 and 2006, wage growth is projected to increase as a result of a tighter labour market and higher inflation. There has been a tendency in recent years for a larger portion of pay increases to be agreed in the first year of the two-year period covered by the main agreement. If we consider these two-year periods together, the estimated relationship between wage growth and developments in the labour market are approximately in line with that observed since the mid-1990s.

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. However, corporate earnings have been low, and until recently enterprises have primarily focused on enhancing efficiency.

Credit developments are giving ambiguous signals to our interest-rate setting. Growth in household borrowing is high, but enterprises are reducing debt. The change in the breakdown of credit may have been amplified by banks' increased eagerness to extend credit to households after a period of losses on loans to the business sector. Some reports from our regional network indicate that there are some restraints on credit for the business sector in some areas. Developments in credit to enterprises shadow developments in their investments. Low credit growth indicates that mainland business investment has not yet picked up. Total credit is expanding broadly in line with normal growth in nominal GDP.

Norwegian households generally finance their mortgages at an interest rate that follows the short-term money market rate. Floating interest rates tend to vary widely over time. The interest rate level is very low at present, and long-term investments cannot rely on this interest rate spanning the life of a housing loan. 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 in line with the level abroad. This interest rate, with a mark-up for banks' margins, provides a more realistic expression of the interest rate level that will apply over the loan's life than the floating interest rate prevailing today.

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 particular demands on banks in assessing the creditworthiness of borrowers. But experience has shown that the underlying cause of loan defaults can be overly optimistic assessments on the part of both the lender and borrower.

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.

Household debt has increased sharply over the past decade. Developments in debt in the 1990s may partly be interpreted as a delayed adaptation to the deregulation of the housing and credit markets in the 1980s after many households experienced financial difficulties following the relaxation.

Household assets and debt and housing wealth have risen at a markedly faster pace than disposable income, and housing wealth has grown more than net debt from 1994 up to the present. The Norwegian economy has experienced both upturns and downturns since 1994, and activity is now approximately on a par with the level prevailing in 1994. These changes must therefore be regarded as structural changes.

We have limited scope for restraining structural changes that occur when households increase their debt over several years to invest in housing and other property and assets. An interest rate that would effectively restrain these structural adjustments would also have an adverse impact on output and employment. The interest rate can be used to reduce credit demand. At present - with low interest rates abroad and a close link between domestic interest rates and the krone - a tighter monetary policy will restrain credit demand primarily because job security would be reduced.

Household credit demand is closely linked to developments in the housing market. Home-owners who have seen the value of their dwellings rise have the possibility of taking up new mortgage-secured loans. They free up a portion of their home equity value to finance consumption and other investments. House prices in Norway have on average risen by 9 per cent annually between 1995 and 2002. House prices have also increased considerably in other countries. A sharp and sustained rise in house prices might contribute to high credit growth even after prices have levelled off. Since only a portion of the housing stock is sold each year, some dwellings will be sold at a higher price than when they were last sold for a long period. This has contributed to sustaining the high level of growth in credit to households in Norway even after the rise in house prices moderated through 2002 and into 2003.

It is easiest to sell dwellings in the largest cities and some specific areas are particularly attractive. Residential property is now a fairly liquid and attractive investment. A persistently high rate of increase in house prices may in isolation engender expectations of a further rise and may thus prove to be self-reinforcing for a period. Moreover, there now seems to be a tendency towards investing in property and incurring loans at a more mature age so that younger generations not only inherit dwellings, but debt as well. Both debt and wealth are on the rise for these more mature age groups.

Sharp increases in asset prices and debt accumulation may pose a risk to economic stability. With a view to mitigating this risk, it will be appropriate in some situations to apply a somewhat longer-than-normal time horizon than two years to attain the inflation target. However, at present debt accumulation is high only in the household sector. There is little borrowing activity in the enterprise sector. House prices are rising, but non-residential property prices are stable. Prices for office premises are, however, stable.

The analyses in the inflation reports indicate that inflation will remain low this year, picking up thereafter. The krone depreciation since January 2003 is expected to push up prices for imported consumer goods. Overall, mainland GDP growth is projected to pick up markedly this year and remain relatively high in 2005 and 2006. GDP growth is projected to reach 3¼ per cent in 2004 and 2005, followed by a slight decline to 2¾ per cent in 2006. With this path for total output, the output gap, as measured here, will shift to slightly positive in 2005 and 2006 from slightly negative this year.

Projections are based on the technical assumption that the interest rate will move in line with forward rates. The assumption implies that the interest rate will be somewhat lower in the near term, but that it will rise gradually from the summer, largely in parallel with the increase in interest rates among our trading partners. The krone is assumed to follow the path of the forward exchange rate, which indicates expectations of a fairly stable exchange rate in the period ahead. A path that is in line with the projections in the previous Inflation Report (IR 1/04) provides a reasonable balance between the prospects for reaching the inflation target and stable developments in the real economy.

The aim of monetary policy is higher inflation. It is appropriate to be particularly vigilant with regard to developments in consumer prices, but consumer prices may show random variations from one month to the next. Later this year, we will receive confirmation of whether consumer prices are rising in line with our projections. When inflation increases from a very low level, this will provide a basis for gradually moving towards a more normal short-term interest rate level in Norway. This may counter excessive credit growth and excessive pressures on domestic resources in the medium term. Interest rate developments in other countries may also have a considerable impact on the krone and hence on Norwegian interest rates.

At its meeting on the 11 March, the Executive Board decided to reduce the interest rate by 0.25 percentage point. In reaching its decision, the Executive Board had weighed the objective of bringing inflation back to target and stabilising inflation expectations against the risk that output growth may eventually become too strong. Furthermore, according to the Executive Board's assessment, with a sight deposit rate of 1.75 per cent at present, the probability that inflation two years ahead will be lower than 2½ per cent is greater than the probability that it will be higher.