Svein Gjedrem: Monetary policy and cyclical developments

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at a meeting hosted by Sparebank 1 at the University Center, Svalbard, 22 April 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 21 April, 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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In many countries, the conduct of monetary policy is delegated to the central bank. In Norway, the responsibility for interest rate decisions was delegated to Norges Bank in 1986. The mandate for the conduct of monetary policy was laid down by the Ministry of Finance in the Regulation on Monetary Policy of 29 March 2001.

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 influences their decisions concerning saving, investment, budgets and wages. Experience shows that there is no long-term trade-off between lower unemployment or stronger economic growth and higher inflation. The task of monetary policy is to provide a nominal anchor. The inflation target is such an anchor.

There are several reasons why it is an advantage that inflation is higher than zero:

- The structure of the economy evolves over time. Demand for labour with different qualifications changes. 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 some 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 percentage point.

The inflation target represents a framework 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 by the ability to adapt, 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 long-term trend growth and in others above trend. The difference between trend output and actual output is called the output gap. Stabilising output growth means seeking to maintain actual output near trend.

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. The economy then shifted from an upturn with high growth rates to an expansion with lower growth but low unemployment, labour shortages in many sectors and strong growth in labour costs. Since 1998, output growth has been low. Growth stalled in winter 2002 and was well below capacity in the first half of 2003. Growth in the Norwegian economy has since picked up.

Norges Bank has not defined an exchange rate target. Nevertheless, developments in the krone are of considerable importance to interest-rate setting because exchange rate developments have an impact on inflation and output. The krone fluctuates. This is not surprising because other countries' currencies also fluctuate. Exchange rate fluctuation is a structural feature of open economies like Norway that have their own currency. The Norwegian krone does not stand out as particularly unstable. On the contrary, in countries like Sweden, the UK, Switzerland, Australia, Canada and New Zealand, exchange rate fluctuations are as wide - or wider - than in Norway.

There is a cost involved for businesses in hedging against fluctuations in the krone. However, a krone that is stable - but too strong - also entails costs in the form of low activity. Similarly, a krone that is stable - but weak - is a source of high inflation. The capital outflow through the Petroleum Fund contributes to both curbing the appreciation of the krone and maintaining its stability.

When inflation in Norway is expected to be broadly in line with that of other countries, the exchange rate will normally also return to its normal range following periods when the krone has been particularly strong or particularly weak. This may provide a basis for stable exchange rate expectations.

Normally, the interest rate is set with a view to achieving inflation of 2½ per cent 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 equity markets burst. Many years of high investment had 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 summer 2002 to spring 2003, a highly unusual accumulation of negative events in the global community - accounting scandals, fear of terror, war and disease - put a brake on growth.

US policy 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. In recent weeks, short- and long-term rates have moved up somewhat. This primarily reflects increased confidence that the recovery in the US will be sustained since the situation in the labour market appears to have improved. Both short and long rates, however, are still at historically very low levels among several of our trading partners.

The economic situation in Norway was more favourable compared with the international trend for a long period, and wage growth was surprisingly high in 2002. As a result, the interest rate differential against other countries was high. This had an impact on exchange rate developments. In addition, special factors 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 autumn 2002, the Norwegian krone was probably also perceived as a safe haven. Over the past 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.

Through 2003, the interest rate differential has 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. Through 2003 and up to March 2004, the krone depreciated by about 15 per cent, measured by the import-weighted index I-44. Since the monetary policy meeting on March, the krone has appreciated again by about 3½ per cent.

Inflation has edged up, but is still low. In March, inflation stood at 0.3 per cent. Apart from some temporary, technical factors that may together account for 3-4 tenths of a percentage point, three main factors have contributed to explaining 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 and other channels. The strong krone contributed to low inflationary pressures. The depreciation in the krone exchange rate since January 2003 has not resulted in a significant rise in prices for imported consumer goods, as might have been expected. In recent months, however, there have been signs of higher prices for imported goods. Clothing prices in particular slowed in March.

- Second, low external inflation and rapid shifts in the international division of labour have 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. We have nonetheless observed that the fall in prices for clothing has been somewhat more subdued in Svalbard than on the mainland, partly due to the higher incidence of snowscooter apparel here. Rapid technological advances have also pushed down prices for audiovisual equipment.
- Third, competition has probably increased in retail trade and other service sectors in Norway in recent years. The establishment of new firms, changes in operating parameters and rationalisation in a number of industries may have contributed to this.

In the first round, 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. Increased competition therefore usually triggers higher productivity growth in the economy. Low inflation may thus be matched by higher productivity.

In recent years, declining inflation has also been a feature in the other Nordic countries, where some of the same factors have played a role.

Even though consumer prices have been low and, in some cases, falling in Norway and abroad, commodity prices in particular have shown a sharp increase. The price of coal, for example, a commodity you are well acquainted with, has shown a marked rise over the past year. Although the rise in commodity prices measured in US dollars is to some extent the result of the fall in the value of the dollar, it also reflects an increase in demand for commodities, which in turn is partly related to strong output growth in China.

Prices for domestically produced goods and services are expected to rise in the period to 2005 due to higher capacity utilisation in the Norwegian economy. 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 prices for imported consumer goods.

Economic developments

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. After a surprisingly long period of weak labour market developments, the latest employment figures indicate that the situation may now have been reversed, although there is still excess production capacity and very low inflation. 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, there have also been signs that inflationary pressures are moderating. Against this background, it will probably take time before interest rates rise markedly in the euro area.

Interest rate expectations were continuously revised downwards up to March this year, and an increase towards a more normal level was postponed in the US and the euro area. Interest rates abroad have been unusually low for 2½ years, and are likely to remain low for some time to come, despite the above-mentioned signs of a somewhat swifter rise. This has been the greatest challenge for our monetary policy.

In Norway, output growth has picked up after a growth pause. The interest rate is an effective instrument. The interest rate reductions since 2002 have contributed to the turnaround and the economy has experienced a soft landing, following the years of high cost inflation in Norway and the cyclical downturn in the world economy. Lower interest rates in particular 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 appears to be continuing 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 is also 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 15 billion in household net interest expenses before tax. However, due to the increase in household net debt, net interest expenses will fall considerably less than this.

The impact of the interest rate decline also depends on how long interest rates are expected to remain low. 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 rise in inflation from February to March, however, gave rise to somewhat higher interest rate expectations and a stronger krone exchange rate.

The outlook for the business sector is brighter now. The fall in the value of the krone over the past year has strengthened Norwegian business and industry. The business sector is, however, still feeling the effects of the 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. Companies that are still in operation may be in a better position to cope with 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 characterise the business sector in 2004. This will curb demand for labour and investment growth this year.

Both in Northern Norway and in the rest of the country, 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 corporate market fell through 2003. Demand for services in this market segment will pick up in pace with increased output in manufacturing and other industries.

Strong competition has resulted in substantial restructuring. In Norway and other countries, manufacturing production is being moved to countries with lower costs. This may continue. EU enlargement, with 10 new members from 1 May, may also increase competition in some industries, particularly in the service sector. Public procurement is subject to EU-wide tendering. This may imply heightened competition for the service sector in Norway and lead to further efficiency measures.

Our regional network reports that demand growth is high in the construction industry in Northern Norway, primarily fuelled by public investment and the Snøhvit oil field project. Similarly, in Western Norway investment in shore-based facilities has generated a positive impetus to the construction industry. Activity in 2003 in the rest of the country has been held up by public investment projects. Information from our regional network indicates that construction activity has picked up markedly in most regions.

In recent year, commercial property 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 vacancy rate. Statistics Norway's new price index for office and 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 end-June 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 development of onshore and offshore infrastructure in order to produce gas from the Ormen Lange field.

At the end of January and beginning of February, our contacts in Region North reported rising demand and output for most industries since autumn 2003. There are prospects of strong growth in all industries except manufacturing for the domestic market. The export industry, however, reported that demand growth is moderate. Restructuring has contributed to growth in the fisheries. High activity in the metals industry is also contributing to increased activity among enterprises providing services to this industry. For the construction industry, demand growth is high. Retail trade continues to show high growth in activity. Developments in the service sector are also positive.

Substantial growth in investment, however, is not expected. Only the public sector, retail trade and other services are planning to invest somewhat more compared with last autumn.

Employment in Northern Norway does not seem to be on the rise in the private or public sectors, with the exception of the construction industry. Firms generally report that they have considerable idle capacity and that they are continuing to rationalise operations. At the same time, selling prices are rising moderately in the export industry and services, but falling slightly in manufacturing for the domestic market. Strong competitive pressures provide limited scope for price adjustments. This applies for example to transport and logistics firms, which are expecting further pressure on prices when the EU enlargement on 1 May makes it easier for foreign competitors to enter the market. Some equipment suppliers, however, announced substantial price rises for some intermediate goods. Profitability is increasing moderately in all sectors except manufacturing.

One third of the labour force in Norway is employed in the public sector. In Northern Norway, this proportion is closer to 45 per cent. The primary industries are important for the counties in Northern Norway, especially because of the abundant fish resources in coastal areas. A large part of the fishing industry is export-oriented and is increasingly competing with low-cost countries. These industries will be vulnerable when the rise in domestic costs is high.

There are wide regional variations in unemployment. At end-February, an average of 4.5 per cent of the labour force in the three northernmost counties was registered as unemployed. This is slightly higher than the national average of 3.9 per cent. Even though the region has somewhat higher unemployment than the national average, the rise in unemployment in Northern Norway has been relatively low in the last year. Finnmark is one of the four counties in Norway to record the sharpest fall in unemployment over the past year.

This snapshot report on the current situation in this part of the country and similar reports from the other regions provide information that is important to interest-rate setting.

The labour market 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 service sectors such as 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 4.4 per cent of the labour force in January.

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. Employment growth is projected to be fairly moderate this year in relation to growth in demand and 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 per cent as substantial increases with effect from 2003 were awarded in the 2002 main wage settlement. Wage growth is projected to decline to 3¾ per cent 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.

In connection with the 2004 wage settlement, the Government has stated that proposals concerning employment-based pensions will be put forward this year, including proposals for certain minimum standards that will be apply to all employees that are not already included in more favourable schemes. The proposal implies that many private sector employees that are not currently covered by a company pension scheme will be included in the proposed scheme. The proportion of employees without any employment-based pension is greatest in retail trade, the hotel and restaurant sector and the construction industry.

Financial stability

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 have reduced 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 are some liquidity constraints for the business sector in some areas. According to reports from Northern Norway, banks seem to have become more cautious in extending loans to the business sector. Banks are requiring higher levels of capital and earning capacity. Total credit is expanding broadly in line with normal growth in nominal GDP.

Developments in credit to enterprises shadow developments in their investments. Low credit growth indicates that corporate investment in the mainland economy has still not picked up even though there seem to be signs that the decline is levelling out somewhat. 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.

When the interest rate is abnormally low, it can be particularly challenging for borrowers to assess their debt-servicing capacity over time. 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 our 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. 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. Debt accumulation is also affected by the business cycle and interest rate changes.

Household credit demand is closely linked to developments in the housing market. Home-owners with dwellings that have risen in value can make use of the opportunity to take up new mortgage-secured loans, freeing up home equity 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, there will for a long period be some dwellings that are sold at a higher price than when they were last sold. 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 taking up 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 time horizon than the usual two years to attain the inflation target. At present, however, debt accumulation is high only in the household sector. There is little borrowing activity in the enterprise sector. House prices are rising, but prices for office space are stable.

Output and employment are at trend level. Unemployment is on a par with the average for the 1990s, wage growth is consistent with the inflation target, credit growth is close to long-term nominal GDP growth, relative labour costs and prices are approximately at the same level as the average for the past 30 years and the interest rate differential is close to zero.

But inflation is low, as a result of the lagged effects of the strong krone, low import prices and high productivity growth.

The analyses in the inflation report 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 moderate decline to 2¾ per cent in 2006. This rise in overall output will then result in a gradual pickup in capacity utilisation in the years ahead.

Projections are based on the technical assumption that the interest rate will move in line with forward rates (4 March 2004). 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 (4 March 2004), which indicates expectations of a fairly stable exchange rate in the period ahead. A path that is in line with the projections in Inflation Report 1/2004 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. When inflation is as low as it is at present, it is appropriate to be particularly vigilant with regard to developments in consumer prices, although 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.

Interest rates were left unchanged at Norges Bank's Executive Board meeting on 21 April 2004. 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 Norges Bank'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.