Svein Gjedrem: The conduct of monetary policy

Introductory statement by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 22 May 2006.

Please note that the text below may differ slightly from the actual presentation. The statement is based on Norges Bank's Annual Report for 2005, Inflation Report 1/2006 and the Executive Board's assessments published after the monetary policy meeting on 26 April.

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

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

Economic policy in Norway faces particular challenges. Low prices for imported goods and services, combined with high prices for export goods, have led to substantial terms-of-trade gains for Norway.

The Norwegian economy has experienced a strong positive income shock. Such a pronounced improvement in the terms of trade has in fact not been observed since the First World War. Real national disposable income will increase by 25-30 per cent in the period 2003-2006.

So far, the increase in income has not led to a pronounced rise in price and wage inflation. Businesses are using resources with steadily greater efficiency and the supply of labour has been ample.

Nevertheless, in the face of such strong external influences, it is demanding to smooth developments in the Norwegian economy. Our stabilisation policy rests on four pillars, which were established in the 1990s and in 2001 against the backdrop of the wide fluctuations in economic developments during the first twenty years of the oil age in Norway. Under the oil fund mechanism, increased government petroleum revenues are invested abroad. This curbs the impact of price fluctuations on domestic demand and production - and on inflation and the krone exchange rate. A floating krone exchange rate also has a stabilising effect, as the exchange rate normally appreciates in favourable periods and depreciates during adverse periods. At the same time, the fiscal rule that provides for a steady phasing-in of petroleum revenues and the inflation target anchor expectations concerning developments in the krone exchange rate and inflation. As a result, the impact of a terms-of-trade change, stemming from variations in the oil price, on these variables becomes less pronounced. Moreover, the fiscal rule contributes to restraining the pace at which exposed industries are scaled back.

In principle, these policy guidelines are just as conducive for coping with favourable periods as with adverse periods. We will face another test when the terms-of-trade change is reversed and the gains either fully or partly dissipate.

Monetary policy in Norway is oriented towards low and stable inflation. This is the most important contribution monetary policy can make to sound economic developments in the long term. Low and stable inflation provides enterprises and households with an anchor for inflation expectations.

In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given both to variability in inflation and variability in output and employment. Flexible inflation targeting builds a bridge between the long-term objective of monetary policy, which is to keep inflation on target and provide an anchor for inflation expectations, and the short-term objective of stabilising economic developments.

Transparency surrounding Norges Bank's assessments of monetary policy trade-offs enhances economic agents' understanding of how economic news influences the interest rate. In recent years, it has become easier to read the Bank's intentions. As a result, monetary policy has become more effective. The background material for the Executive Board's monetary policy meetings is published and the assessments underlying the interest rate decisions are explained. As from last autumn, the Bank publishes its own interest rate forecast. From using technical assumptions and others' assessments, we have taken ownership of the interest rate path in our projections. Even though considerable uncertainty still remains, it becomes easier for economic agents to assess interest rate developments.

Weak growth in the world economy early this decade led to low interest rates in many countries. Interest rates were kept at a low level for a long period, but are now on the rise. The world economy is again expanding at a brisk pace. Over the past three years, global production has increased by about 14 per cent, which is the strongest upturn since the beginning of the 1970s.

In the UK and US, interest rates have already moved up to a more normal level. In Sweden and the euro area, the central banks have started to raise interest rates. Over the next year, further interest rate increases are expected in the euro area, the UK, Sweden, Switzerland, the US, Canada, Japan and Australia.

Norway has also experienced a fairly long period of falling and thereafter stable, low interest rates. Price inflation was subdued, and there was idle capacity in the economy. Real interest rates have been very low and markedly lower than a neutral level. In line with the prospects I presented to the Committee last year, we have started raising interest rates. To date, Norges Bank's key rate has been increased by 0.75 percentage point.

Consumer price inflation has edged up, but is still very low even close to three years after the start of the cyclical upturn. Consumer prices adjusted for tax changes and excluding energy products have risen by 1 per cent over the past twelve months1. Prices for imported consumer goods have fallen almost every year since the mid-1990s, reflecting freer trade and the shift towards imports from low-cost countries.

The rise in prices for domestically produced goods and services slowed somewhat towards the end of 2005 and into 2006. The 12-month rise in prices for these products was 1.6 per cent in April[1].

Several factors now point towards higher inflation. Capacity utilisation in the Norwegian economy is increasing. This may result in higher margins. Furthermore, tighter labour market conditions may lead to higher wage growth. In addition, the rise in energy and commodity prices is pushing up producer input costs.

Buoyant growth in the global economy has contributed to very high prices for oil, gas and other commodities. Since last autumn, copper prices have more than doubled and aluminium prices have risen by close to 50 per cent. Commodity futures prices have also increased markedly. Prices for other Norwegian export goods, such as fresh salmon, have also exhibited a marked rise.

As mentioned by way of introduction, falling prices for imported consumer goods, in conjunction with rising prices for Norway's export goods, have contributed to substantial terms-of-trade gains for Norway. Over the past few years, Norwegian export prices have increased twofold relative to import prices. The impact of the rise in oil and gas prices is particularly strong, but the terms of trade for the mainland economy have also improved. The situation in Norway differs from that of its Nordic neighbours. Sales of Swedish and Finnish high-tech products are growing strongly in volume terms, but prices are falling. Denmark has a diversified business sector, which is overall moving on a steady path.

Partly reflecting the improvement in the terms of trade, the nominal krone exchange rate has remained strong. Wage costs in Norway are now very high compared with other countries, measured in a common currency. The current situation is considerably different from that of the mid-1990s. At that time, performance in the manufacturing sector was strong partly owing to solid competitiveness. Today, the manufacturing sector is faring well in spite of a strong krone and a high cost level. The reason is the unusually buoyant markets for Norwegian goods. At the same time, the strong krone exchange rate has eased the impact of revenue gains. In periods, the effects on the krone may nevertheless be somewhat excessive, partly owing to the low level of inflation in Norway.

Low interest rates, increased petroleum investment, strong global growth and the improvement in the terms of trade have contributed to solid growth in the Norwegian economy. Capacity utilisation has probably reached a higher-than-normal level, and the cyclical upturn is continuing. Enterprises are steadily increasing their debt to finance investments. So far, the cyclical expansion has been marked by strong production growth, with ample labour supply and unusually low inflation.

1 Adjusted for lower maximum day-care rates.

For a long time, employment growth measured by number employed was lower than in previous upturns, partly reflecting the fall in sickness absence as of summer 2004. In 2005, the number of person-hours worked increased relatively rapidly and productivity growth picked up. This may have limited the demand for new labour. This trend has now been reversed. Employment growth measured by number employed is strong. Our regional network reports that there are labour shortages in many sectors.

The wage settlements concluded so far indicate that wage growth may, as expected, be somewhat stronger this year than in 2005. Historically, it has proven difficult in both local and central negotiations to keep down cost growth when unemployment is low. There is thus a risk of even higher wage growth further ahead. On the other hand, the threat of relocation of jobs, increased labour inflows and higher imports of services from low-cost countries will probably contribute to restraining wage growth. In the period 1998-2002, businesses and employees experienced that high wage growth resulted in high interest rates and wide fluctuations in the krone exchange rate. This insight is perhaps still marking wage negotiations.

The phase with ample labour supply may be in the process of tapering off. The decline in sickness absence has been reversed, and is now increasing. As was the case earlier, the number of persons on disability benefits is rising. The supply of labour from other countries is important for many industries, but on the whole is no longer offsetting increased flows into benefit schemes. There is competition for highly skilled labour in the new EU accession countries. Labour flows into the UK and Ireland have been particularly high and labour barriers may be more restrictive in Norway than in the UK and Ireland. Activity has picked up in Central European countries, and the Swedish labour market has become tighter. Therefore, it is uncertain how large the supply of labour from these countries will be in the period ahead.

Household debt has risen sharply since the mid-1990s. At the same time, house prices have increased markedly. To some extent, developments in the 1990s can probably be viewed as a delayed adaptation to the deregulation of the housing and credit markets in the 1980s, after many households burned their fingers in the wake of deregulation. In recent years, household income growth has been solid and household confidence in the future is very high. Coupled with expectations of low real interest rate over time, this may have provided an additional boost to house prices.

Long periods of sharply rising asset prices and debt may be a potential source of subsequent instability in output and employment.

The sharp rise in house prices and debt in other countries are probably also ascribable to low real interest rates over time. Household debt is high in Norway, but is even higher in Denmark and the Netherlands. This probably reflects a long history of well developed mortgage financing in these countries.

Inflation stabilised early in the 1990s after falling from a high level in the previous decade. Through the 1990s, inflation generally remained in the interval 1½ – 3½ per cent. Inflation has varied slightly more in the past few years. In a period of increasing cross-border labour flows, major technological advances, changes in competitive conditions and substantial changes in trade patterns, inflation will probably, with our very open economy, show somewhat wider variations, as witnessed over the past two to three years.

The operational objective of monetary policy is low and stable consumer price inflation. Over time, the consumer price index will provide a guide for assessing monetary policy. Monthly variations in consumer prices reflect temporary conditions which monetary policy cannot control. According to Norges Bank's remit, the Bank shall not normally take account of direct effects on consumer prices of changes in interest rate, excise duties and extraordinary, temporary disturbances. Energy prices have traditionally shown wide variations. Hence, a price index that is adjusted for variations in such prices as well as for indirect taxes can be a measure of underlying inflation in the economy.

However, such a price index does not take account of that fact that the trend rise in energy prices has been higher than for other prices and is therefore not a perfect measure of underlying inflation. In the past 10-20 years, energy prices and taxes have pushed up consumer prices annually by an average 0.35 percentage point. Even when taking into account trend increases in energy prices, inflation is still moderate.

Experience indicates that inflation expectations remain stable even if inflation varies somewhat, as long as the interest rate is used actively to curb the effects.

Norges Bank seeks to set the interest rate with a view to achieving a reasonable balance between the objective of stabilising inflation at target and the objective of stabilising developments in output and employment.

Interest rates are projected to increase gradually in the years ahead, up to a more normal level. Interest rates are also expected to increase in other countries. Capacity utilisation in the Norwegian economy is now fairly high and will contribute to bringing inflation up towards the target in the course of the next 2-3 years. In the account presented after the monetary policy meeting of the Executive Board on 26 April, it was stated that there are prospects of another interest rate increase in the second quarter – at the monetary policy meeting in May or June – and a further increase thereafter.

In addition to projecting developments, we wish to highlight the uncertainty surrounding developments ahead. The projections for the interest rate and other economic variables are based on incomplete information about the current economic situation and the functioning of the economy.

Allow me to summarise:

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

Economic policy must increasingly reflect the capacity constraints facing many Norwegian businesses. There are prospects that the interest rate will be raised gradually – in small, not too frequent steps – towards a more normal level.

Thank you for allowing me to make the introductory statement at this hearing.