

Svein Gjedrem: Monetary policy and the labour market

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference to mark the 10th anniversary of the Federation of Norwegian Professional Associations, Oslo, 24 October 2007.

The text below may differ slightly from the actual presentation. The speech does not contain assessments of the economic situation or the monetary stance.

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The Norwegian economy is expanding sharply after the strong upturn began in summer 2003. The upturn followed a period of slow growth from 1998 and a mild slowdown in 2002 and into 2003. Growth has been stronger than in the cyclical upturn in the mid-1990s. The high rate of growth has only to a limited extent fed through to a higher rise in prices for consumer goods and services. Electricity prices have fallen sharply this year, contributing to low inflation and high real wage growth. But even excluding energy, inflation is still low, even though it has gradually picked up since late summer 2006.

In recent years, the Norwegian economy has been influenced by a number of positive supply-side factors.

First, high export prices and low import prices have resulted in a substantial improvement in Norway's terms of trade. We can now import considerably more for a given quantity of export goods.

Second, productivity growth has been unusually strong, both for companies competing on international markets and those supplying goods and services to the domestic market. In comparison with other countries, productivity gains in banks and other service sectors stand out in particular. Examples are automated processes and swifter payments in the financial industry, and improved inventory and management systems in commerce and transport. This reduces production costs. The business sector is quick to adapt and change, and to make use of new technology that is available in an international market. This is probably due to the modernisation in the 1980s and 1990s of the way the economy functions, which resulted in more efficient markets.

Although satisfactory current statistics for central government and local government productivity are not available, government agencies have probably also become more efficient. New technology and new organisational structures have certainly provided opportunities to increase efficiency.

Third, an ample supply of foreign labour has been an important factor behind output growth. In particular, the supply of foreign labour has increased sharply after EU enlargement in 2004.

Improved terms of trade, high productivity growth in the Norwegian business sector and the increase in labour supply have resulted in a favourable environment for the Norwegian economy. Unemployment has declined considerably and is now very low. The labour market is tight. Unemployment has not been as low since the second half of the 1980s, and employment has risen sharply this year.

Wage-earners and enterprises have both fared well. Cheap imported goods have resulted in a subdued rise in consumer prices and a substantial increase in wage-earners' real wages. High export prices have restrained the rise in real labour costs. Combined with high productivity growth, this has resulted in high corporate earnings and solid growth in employment.

At the same time, wage-earners share of corporate value added has been reduced, from around 75 per cent at the end of the 1980s to 70 per cent at the end of the 1990s, and now

stands at below 65 per cent. Solid productivity growth and high prices for export goods and deliveries to the petroleum sector have contributed to the reduction in the wage share over the past few years. The ample supply of labour has probably had a dampening effect on wage growth. Increased globalisation may have provided greater opportunities for Norwegian enterprises to relocate production to other countries if labour costs become too high. This probably places some restraint on wage demands among workers in sectors where enterprises have such opportunities.

Historically, a high wage share has tended to be accompanied by low unemployment. Developments in recent years have provided the basis for strong growth in employment while the wage share has fallen.

Is it possible to sustain the combination of low unemployment and a low wage share?

First, it partly depends on whether the positive supply-side conditions are sustained. There is probably symmetry here. Should the terms of trade deteriorate, productivity growth slacken and foreign workers return to their home country, the wage share will increase, profits fall and unemployment increase.

There is now a prospect of slower global growth. There are also signs that the strong growth in productivity that has been evident in other countries – for example in the US – is moderating somewhat. And we may see a similar trend in Norway.

Second, even without a reversal, profits may fall and unemployment rise. The implications of this will depend on how far businesses, in their search for qualified labour, will go in bidding up wages. It will also depend on how wage-earners react and on their ability to adapt to change. Furthermore, it must be expected that the strong krone will shave profits in some enterprises and industries at the moment, even though many have used currency hedging to safeguard their income.

Even though demand for labour is strong, there is a risk that outflows from the labour market to various social security schemes will remain high. Sickness absence is high, and the share of the working-age population on rehabilitation schemes or receiving disability pensions is rising. Many workers choose to take early retirement under the AFP scheme (contractual early retirement) when they reach 62 years of age, and – because this age group is expanding sharply – this number will probably increase in the years ahead. In Norway, close to 600 000 persons of working age receive social security benefits or pensions. This is equivalent to 25 per cent of the labour force. This is the Norwegian economy's Achilles' heel. A particularly disturbing aspect is that disability is increasing among young people¹.

High income growth and a sharp rise in the number of households laid the basis for a sharp, long-term rise in house prices. Self-reinforcing mechanisms were also at work, generating an atmosphere approaching euphoria. People hurried to buy dwellings in order to take advantage of the rise in value. It now appears that the housing market is cooling after an almost three-fold rise in prices in real terms in the course of the past 14 years. House price inflation has been accompanied by strong growth in household debt. Household debt in Norway is now about twice the level of disposable income, making the debt-income ratio higher than ever. At the same time, saving is declining and now seems to be negative. This means that in addition to fully financing their housing investments through mortgages, households are also raising loans to finance current consumption.

As I mentioned earlier, the favourable developments in the Norwegian economy of the past few years are primarily due to supply-side changes. A flexible inflation target for monetary policy – as in Norway and a number of other countries – provides a sound basis for coping with the shocks to our economy that have occurred in recent years. The aim of preventing

¹ See Elisabeth Fevang og Knut Røed (2006): "Veien til uføretrygd i Norge" (The road to disability pensions in Norway), Report No. 10 2006, Ragnar Frisch Centre for Economic Research. Norwegian only.

inflation expectations from becoming entrenched below the operational target of 2.5 per cent was one of the main reasons the interest rate was lowered to a very low level in 2003 and 2004, when inflation receded and approached zero. Low interest rates have stimulated demand and output and gradually led to the prospect of higher inflation, which we are addressing by increasing the interest rate. Consumer price inflation is still fairly low, but capacity utilisation is now at such a high level that inflation is projected to move up gradually to 2.5 per cent. Higher interest rates will contribute to a gradual decline in capacity utilisation, thereby preventing inflation from becoming too high.

In the long term, monetary policy cannot influence real economic variables such as output and employment; it can only influence nominal variables such as inflation, the nominal interest rate and the nominal exchange rate. When monetary policy serves as an anchor for inflation expectations, it allows the interplay between monetary policy and other components of the economy to function.

A good result can be achieved if the social partners take the role of "leader" and the central bank the role of "follower". Wage growth can then be determined in the knowledge of the monetary policy response. Flexible inflation targeting provides a fixed framework for monetary policy and gives a clear indication of how the central bank is to respond in different situations. The "leader" – the social partners – can internalise the monetary policy response and take the "follower's" – Norges Bank's – response to their actions into account. This approach is most relevant when wage setting is centralised. A number of studies² have shown that countries with a relatively high degree of centralisation and coordination, such as Norway, can achieve relatively low unemployment. When wage-setting is decentralised, monetary policy will instead influence wage growth via market mechanisms, by stabilising aggregate demand for goods, services and labour. Monetary policy that is flexibly oriented towards low and stable inflation will function well whether wages are set at the central, local or individual level².

In the initial period after the introduction of the inflation target in 2001, it appeared that the social partners had not yet internalised the response pattern ensuing from the monetary policy mandate. We are now well into a cyclical phase with very high capacity utilisation and low unemployment. In this situation, there may be a risk that wage growth will again accelerate. On the other hand, the experience gained by the social partners that large pay rises push up interest rates may have the effect of curbing pay increases. In local wage negotiations at enterprise level, competition, the supply of foreign labour and the possibility of outsourcing or relocating activities may dampen the impact.

Low and stable inflation should not be taken for granted. Norway's and other countries' economic history shows that inflation and inflation expectations can become unhinged. There are many self-regulating mechanisms in the economy, but inflation does not regulate itself.

The inflation target of 2.5 per cent also provides a framework for the social partners. Over time, nominal wage growth above 2.5 per cent will entail higher real wages and higher purchasing power. Real wage growth that exceeds productivity growth may lead to higher inflation and higher interest rates.

In government-financed enterprises, which are often labour-intensive, budgets are adapted to expected wage growth. This is usually in line with assumptions about cost inflation in the economy as a whole and with the inflation target. If wages rise more than this, efficiency must be increased in order to minimise the adverse impact on service production and customers.

² Calmfors and Driffill (1988): "Bargaining structure, corporatism and macroeconomic performance", in *Economic Policy*, April, 14-61 and Driffill (2006): "The Centralization of Wage Bargaining Revisited. What have we learned?" in *Journal of Common Market Studies*, Vol. 44, no. 4, November, 731-756.

All economic agents can plan ahead on the assumption that inflation will be about 2.5 per cent over time. This is the most valuable contribution Norges Bank can provide the social partners and other economic agents.

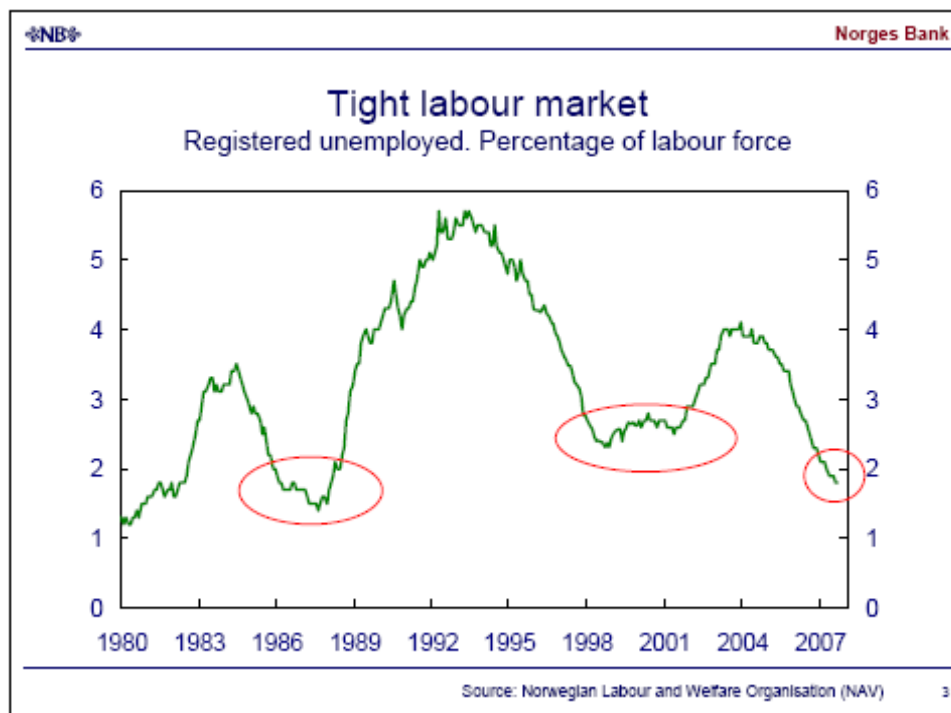
Thank you for your attention.

Norges Bank

Favourable developments in Norwegian economy

- Improved terms of trade
- High productivity growth
- Increased supply of labour

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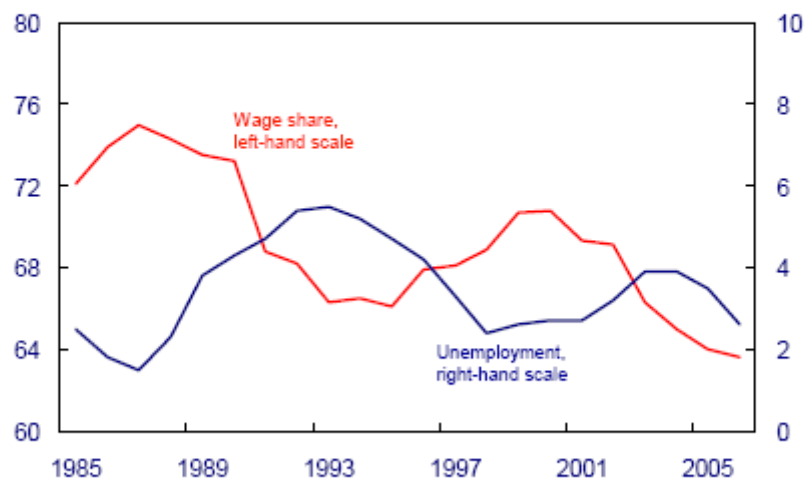
Employees' and firms' real earnings Percentage growth



Sources: Statistics Norway and Norges Bank

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Wage share¹⁾ and registered unemployment Per cent. 1985 – 2006

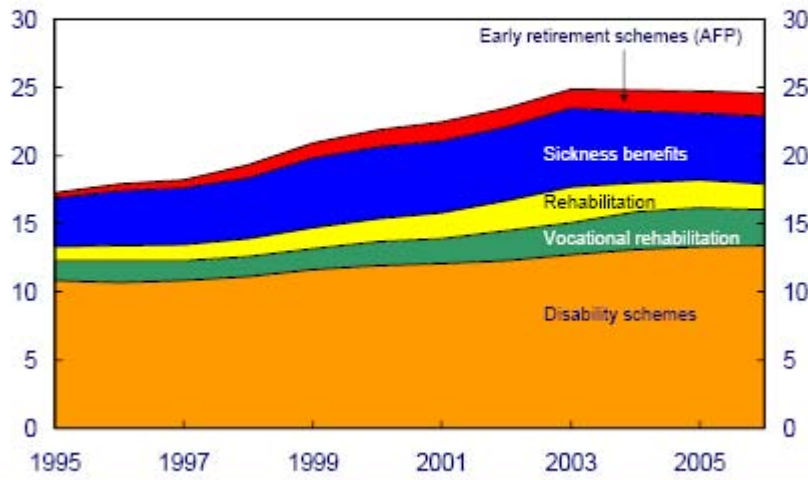


¹⁾ Labour costs as share of factor income. Market-oriented enterprises in mainland Norway.

Sources: Statistics Norway, Norwegian Labour and Welfare Organisation (NAV) and Norges Bank

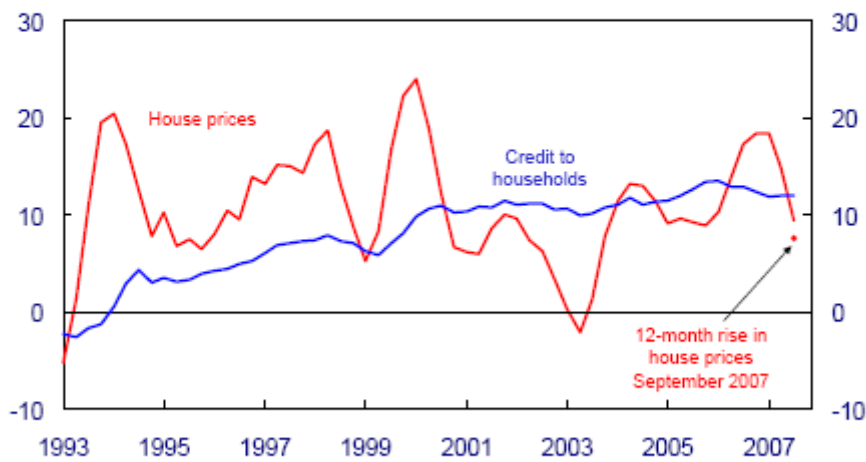
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Persons on benefit and early retirement schemes Per cent of labour force. 1995 – 2006



Source: Norwegian Labour and Welfare Organisation (NAV) 6

Rise in house prices and credit to households 4-quarter rise



Sources: Association of Real Estate Agents, ECON, Finn.no and Association of Real Estate Agency Firms and Statistisk Sentralbyrå 7

Key policy rate and inflation measured by CPI-ATE

Per cent



Source: Norges Bank 8

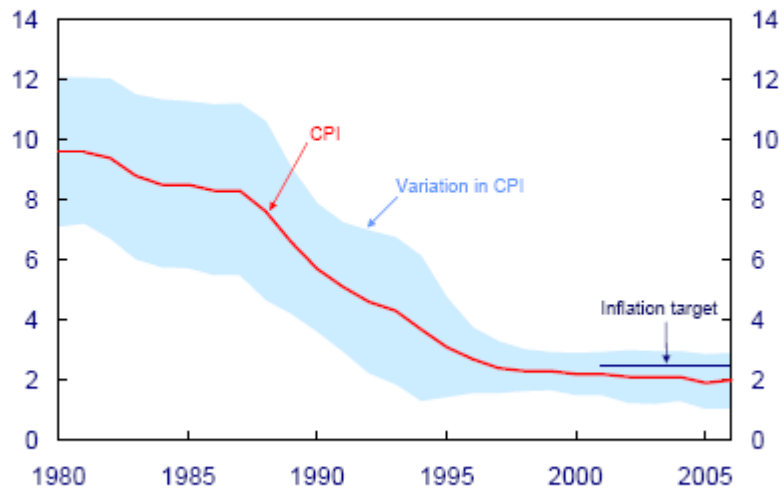
Interplay in economic policy

- Norges Bank's response pattern is consistent with the inflation target set by Government and Storting
- Social partners: "Leader"
 - take Norges Bank's response to their actions into account
- Norges Bank: "Follower"
 - sets the interest rate depending on the effects of wage developments on inflation

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Low inflation

10-year moving average and variation in CPI. Per cent. 1980 – 2006



Sources: Statistics Norway and Norges Bank