The economic outlook

Address by Governor Øystein Olsen to invited foreign embassy representatives, Norges Bank, 29 March 2011.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 16 March, Monetary Policy Report 1/11 and previous speeches. Please note that the text below may differ slightly from the actual presentation.

Excellencies, Ladies and Gentlemen,

I am happy to continue the tradition of my predecessor by inviting you to Norges Bank to discuss economic developments in Norway.

Economic Trends

During the past few weeks, the world's attention has been focused on the sufferings caused by the earthquake in Japan, as well as escalating political unrest in Middle East countries. The economic impact of these events is still uncertain. Apart from these, the economic and financial news of the past year has, on balance, been positive. The global recovery has gained strength, even though uncertainties persist.

A common feature of the countries that fared well through the financial crisis was that they had kept their house in order. Norway falls into this group, although our abundant natural resource wealth puts us in a unique and favourable position. Against this backdrop, I would like to comment on our experience with implementing the prevailing frameworks for monetary and fiscal policy.

Today we can look back at ten years of inflation targeting and the fiscal rule. Despite the financial crisis, this has been a golden period for Norway. Economic developments have been influenced by changes in global trade patterns. Asia has replaced Europe as our main trading partner for many goods, and Norway has reaped significant gains from terms-of-trade effects. National income is almost 30 per cent higher in real terms than ten years ago.

<Chart: Contribution to world GDP growth>

While in the 1980s the advanced economies clearly dominated the performance of the global economy, the contribution to global growth of the emerging economies during the last decade, substantially exceeded that of the advanced economies. Moreover, during the global crisis of 2008-2009, growth in emerging economies was sustained, while it fell sharply in the OECD area.

As growth in the advanced economies now remains depressed, emerging economies will continue to dominate the performance of the global economy.

This tendency is reflected in developments in the global oil market, where the composition of crude oil consumption has shifted from advanced to emerging market economies.

<Chart: global demand for oil>

During the last decade, global demand for oil increased by slightly more than 12 per cent. Over the same period, demand for oil in OECD countries fell by nearly 5 per cent. Commodity-intensive industrialisation and strong per capita income growth in emerging economies are likely to reinforce the upward shift in aggregate commodity demand.

The Norwegian macroeconomic framework

<Chart: GDP growth and terms of trade>

The changing structure of the global economy helps to explain the economic shift experienced in Norway during the 2000s. Prices for Norwegian exports, such as oil, gas, metals, minerals and fish, rose markedly, while prices for imported goods fell. In the seven years leading up to the financial crisis, the volume of mainland GDP expanded at an average annual rate of 3.4 per cent.

Exactly ten years ago today, Norges Bank was charged with the task of setting the interest rate with a view to keeping inflation low and stable. At the same time, new fiscal policy guidelines, also known as the fiscal rule, were implemented, charting a course for petroleum revenue spending. Norway's sovereign wealth fund, which is now called the Government Pension Fund Global, was designed to prevent fluctuations in oil prices from feeding through to the mainland economy.

A decade of inflation targeting

<Chart: Inflation>

The inflation target for monetary policy provides a sound anchor for inflation expectations. Over the past decade, CPI inflation has varied to some extent. Underlying inflation has naturally been more stable, but has been both higher and lower than the target. If we look at the ten-year period as a whole, inflation has been 2 per cent, that is to say close to the target.

Still, over the past ten years, the conduct of monetary policy has been tested. During this period, we have gained insight into the functioning of the Norwegian economy under an inflation-targeting regime. Let me touch upon some of these insights.

<Chart: Krone exchange rate, inflation and Norges Banks key policy rate>

At the beginning of the decade, we learned that it can be demanding to strike a balance between different monetary policy considerations in a small, open economy. When the key policy rate is raised to restrain a pronounced rise in domestic cost inflation, it can have a strong impact on the krone exchange rate, as observed in 2002-2003. This influences both the real economy and the inflation outlook.

Midway through the decade, inflation rapidly declined. China's entry into world trade and increased imports to Norway from Asia led to a persistent fall in prices for many goods. The combination of low inflation and strong economic growth posed a challenge to the conduct of monetary policy. Interest rates – both at home and abroad – were set at low levels. At the same time, this amplified the cyclical upturn in Norway.

Towards the end of the decade, during the financial crisis, the interest rate was reduced sharply and to record-low levels. The decision to lower interest rates was undoubtedly not a difficult decision to make at the time. A persistently low interest rate, on the other hand, can pose a challenge to financial stability in an economy where there is a strong willingness to borrow and property prices are rising.

<Chart: Price level and GDP>

Despite challenges met over the past decade, inflation has been fairly stable and close to the target, which shows that monetary policy has been effective. Compared with the 1980s, for example, inflation has been considerably lower and growth in the mainland economy has been markedly higher. There has been no conflict between low inflation and high economic growth, as previously claimed by economists.

The guidelines and the financial crisis

The financial crisis in 2008 put our economic policy guidelines to a severe test.

The interest rate cuts that followed from the inflation target led to a reduction in households' annual interest expenses of around NOK 40 billion, or around 4 per cent of their disposable income. The krone depreciated and acted as a buffer. The burden on leveraged companies was eased and investment projects became profitable in an environment of lower interest rates. Altogether, monetary policy made a substantial contribution to Norway's resilience to the crisis.

<Chart: Monetary policy during economic downturns>

Well anchored inflation expectations made monetary policy effective – the reduction in Norges Bank's key policy rate was perceived as a decline in the real interest rate. Other central banks experienced that there was little scope for reducing the real interest rate to a sufficiently low level.

This downturn contrasts sharply with the downturn in the 1980s when the interest rate had to be maintained at a high level to defend the krone exchange rate. At that time, there was a lack of confidence in both monetary policy and fiscal policy. The costs were substantial. Unemployment increased, in line with that experienced in some European countries today.

When the financial crisis reached Norway in 2008, we were in a much better position. A long period of substantial petroleum revenues – and a clear savings plan – had provided us with considerable leeway. As a result, fiscal policy could also be used effectively during the downturn. The guidelines stipulate that the government budget deficit shall over time be equivalent to 4 per cent of the capital in the Government Pension Fund Global, – more in bad times, less in good times.

<Chart: Fiscal policy>

A fall in output and employment automatically leads to reduced taxes while unemployment benefits increase. An important aspect of the fiscal rule is that it allows these effects to translate into a weaker budget balance. These automatic stabilisers generated strong impulses through 2009 and 2010, amounting to more than NOK 40 billion for the two years as a whole.

The increase in the Government Pension Fund Global provided, under the fiscal rule, room for a NOK 25 billion increase in spending. The government and the Storting approved additional spending, bringing the overall contribution from fiscal policy to more than NOK 100 billion, equivalent to 5.5 per cent of mainland GDP, over these two years. Few, if any other countries provided such strong fiscal stimulus during the crisis.

The guidelines from 2001 provide a clear long-term framework for monetary policy and fiscal policy. They also provide for cyclical adjustments in economic policy – in part automatically and in part by discretion. In this way, the guidelines reconcile the need for a flexible approach to macroeconomic management with the gains brought by a commitment to more long-term operational objectives.

Lessons from the financial crisis

<Chart: Household debt>

Even though Norway has fared well through the financial crisis, helped by a sound economic policy framework, some concerns related to financial stability remain. In particular, there is one area in which Norway differs from other countries in a manner we perhaps do not like: Norwegian households are among the most heavily indebted in Europe.

As activity in the Norwegian economy is gathering momentum, pressures are mounting in the housing market. Consumer confidence has improved and house prices have risen in recent months. Housing starts are moving up, although from moderate levels.

<Chart: Household debt burden and interest burden>

So far, the low interest rate level has not led to a pronounced increase in household borrowing. However, the household debt burden is at a historically high level and is expected to increase further.

Rising debt and property prices are mutually reinforcing phenomena. Higher asset prices lead to higher collateral values for loans and increased borrowing opportunities for buyers. This increases the overall risk of the financial system.

While monetary policy and fiscal policy have been anchored within a long-term, operational framework over the past ten years, there has been no coherent regulatory system for financial markets. Requirements are currently imposed on individual banks, but without adequate regard to overall risk in the financial system. The financial crisis highlighted the need to strengthen the current framework.

Regulation of the financial sector must secure financial stability, but at the same time protect the public against losses. This is now on the agenda in Norway and in other countries.

I would like to highlight three main aspects of the new regulations that are now underway:

First, the financial crisis revealed that banks held insufficient capital, excessive short-term market funding and inadequate liquidity buffers. The new Basel III framework sets out stricter requirements.

Second, the new framework includes macroprudential tools that can be applied when necessary. Banks may be subject to additional capital requirements if credit growth in the wider economy is excessive.

Third, the authorities must acquire tools that enable banks to be wound up in an orderly manner. Owners and creditors – not taxpayers – must bear the losses. The interest rate on banks' funding will then reflect the risk they take rather than an implicit government subsidy.

The outlook

<Chart: GDP at constant prices>

Despite some concerns regarding financial stability, the Norwegian economy must be characterised as strong. Productivity fell somewhat through the downturn, but has picked up again. Compared to our neighbouring countries, unemployment in Norway is low, around 3 per cent of the labour force. In 2010 the return on our oil fund was close to 10 per cent, and the capital has passed 150 per cent of mainland GDP.

<Chart: Oil price>

In the twelve months since January 2010, oil prices have risen to over USD 100. This development is primarily demand-driven, fuelled by strong growth in the global economy, and in emerging market economies in particular. More recently, oil prices have increased further as political unrest in North Africa and the Middle East has led to uncertainty regarding future oil supply.

<Chart: Terms of trade>

Norwegian manufacturing industries are also benefiting from high commodity prices. Increased profitability for many firms and rising real disposable income may boost the demand for labour. With the prospect of continued high commodity prices and falling import prices, Norway's terms of trade should hold up in the period ahead.

This, together with a tight labour market, may fuel wage growth. Looking ahead, cost inflation is most likely to edge up. On the other hand, high net immigration may have a dampening impact on wages.

<Chart: Immigration in 2010>

In 2010, the population rose by 62 000, an increase of 1.3 per cent. Low unemployment and a relatively high wage level have made the Norwegian labour market attractive to job seekers of foreign origin.

<Chart: Capacity utilisation and inflation>

Going forward, continued high labour immigration is expected to result in solid growth in the labour force. At the same time, improved terms of trade will led to higher activity in the Norwegian economy. Capacity utilisation is expected to revert to a normal level in the second half of 2011. In the coming years, output in the mainland economy is expected to increase at an annual rate of 3–4 per cent.

A strong krone and low external price impulses will continue to have a dampening impact on inflation, and inflation will remain below target for some time. Further ahead, higher capacity utilisation and profitability in the business sector point to a pickup in wage growth. At the same time, the fall in import prices will slow.

To conclude: Norway has weathered the financial crisis better than most countries, and the economic recovery in Norway is now on a firm footing. Currently, interest rates are low, with the key policy rate at 2 per cent.

In the years ahead, there are prospects for fairly strong growth in the Norwegian economy, driven by solid income growth, rising investment and high population growth.

<Chart: Key policy rate>

On balance, the consideration of stabilising inflation, as well as developments in output and employment, imply a gradual increase in the key policy rate towards a more normal level.

Thank you for your attention.