Outlook for the Norwegian economy

Address by Deputy Governor Jan F. Qvigstad for Sparebank 1 Fredrikstad, 4 November 2009.

The text below may differ slightly from the actual presentation. The speech is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 28 October and Monetary Policy Report 3/09.

Chart: Inflation. Moving 10-year average

The operational target of monetary policy in Norway is low and stable inflation, with annual consumer price inflation of close to 2.5 per cent over time. In recent years, average inflation has been close to, but somewhat below 2.5 per cent. Consumer price inflation has generally been somewhat below target since 2003 and monetary policy was then oriented towards pushing up inflation. In 2007 and 2008 inflation picked up to slightly above target. Inflation expectations were firmly anchored and the key policy rate was gradually raised to a more normal level. Inflation close to target and firmly anchored inflation expectations were essential for monetary policy to be effective when substantial cuts were made in the key policy rate in autumn 2008 and the beginning of 2009.

Chart: Credit risk for selected banks and money market spreads

It has been a year since financial turbulence developed into a full-blown crisis and resulted in the most severe downturn in the global economy since the Second World War. The financial crisis eroded confidence in banks, counterparties and contractual partners.

The measures implemented by central banks and governments have had a stabilising effect on financial markets. Credit and money market premiums have decreased and activity has picked up. Daily fluctuations have become less pronounced.

Chart: Indicator of world trade and manufacturing in OECD and emerging markets

With the improvement in financial markets over the past six months and the increase in the credit supply, global trade is now picking up slightly, albeit only gradually and from a low level. Manufacturing output has recently risen in the US, Japan and many emerging economies, while it continues to fall – albeit at a slower pace – in many euro area countries. Manufacturing output in Japan and the US is still at a very low level. Despite the pickup in growth, capacity utilisation in advanced economies will remain very low for the next two-three years.

Chart: International equity markets

Uncertainty in equity markets has eased and risk premiums are lower, reflected in a rise in leading US stock indices of more than 50 per cent since equity markets bottomed out at the beginning of March 2009. Oslo Børs has risen by about 70 per cent since the beginning of March.

Chart: Oil price (Brent Blend) and commodity prices

The price of oil has risen somewhat since the June Report, and has doubled since the trough in December 2008. Metals prices have also risen. The increase in oil prices reflects low growth in oil production, more positive expectations as to the world economy and a weaker US dollar.

Chart: Spare capacity in OPEC and US crude oil and refined product inventories

On the other hand, OECD oil inventories are still ample and OPEC spare production capacity is higher than in the preceding years, while oil demand remains weak.

Chart: Key rates and estimated forward rates

Key rates are close to zero in many countries. Several central banks have signalled that key rates will be kept low for a long period, and key rate expectations abroad have fallen. Pricing in the market indicates an expected rise in key rates in a number of countries after the turn of the year.

Chart: Effective exchange rates

The krone depreciated considerably in the second half of 2008, but has since appreciated again. Stronger risk appetite and market expectations of a somewhat earlier rise in interest rates in Norway have probably contributed to the krone appreciation. Lower capital outflows from the Government Pension Fund – Global have probably also made a contribution. Trading in NOK has picked up since summer and foreign exchange market liquidity has improved.

The projections are based on the assumption that the krone will depreciate somewhat from the current level. It is for example assumed that the real krone exchange rate will gradually revert to its historical
average.

The krone is floating and fluctuates somewhat. It has shown a tendency to appreciate in favourable times and fall in value in response to negative shocks in the Norwegian economy. Nonetheless, budgetary policy and the petroleum fund mechanism contribute to stability in the krone, as is clearly reflected in the movements in the krone in recent years compared with the currencies of other open economies with substantial exports of raw materials, such as Australia and New Zealand.

Chart: GDP growth

The outlook for the Norwegian economy is better than for most other advanced economies. The rebound in activity will probably occur more rapidly, with inflation maintaining a somewhat higher level than in many other countries. Monetary policy measures, combined with petroleum investment and growth in public spending, have boosted activity. The downturn in the Norwegian economy may be relatively mild.

Chart: Countercyclical policy using unconventional measures

The Norwegian authorities implemented a range of measures to mitigate the impact of the crisis on the Norwegian economy. As a result, the liquidity crisis did not turn into a bank solvency crisis or a crisis in the real economy.

Norges Bank reduced the key policy rate considerably last autumn. The key policy rate has been reduced further in 2009 to 1.25 per cent. Norges Bank also stepped up its supply of liquidity to banks in the form of short- and long-term loans. The arrangement whereby banks could exchange covered bonds (OMF) for government securities made a contribution to securing long-term funding for banks. Strong growth in government spending fuelled demand for goods and services.

The authorities supply risk capital to Norwegian banks through the Norwegian State Finance Fund to strengthen banks' solidity. The Government has also provided increased loans and guarantees to Norwegian export industries, and has raised lending limits for state banks. In addition, Folketrygdfondet (the Government Pension Fund – Norway) has been permitted to increase its purchases of bonds.

Chart: Unwinding the extraordinary measures

The extraordinary monetary and liquidity measures implemented were tailored to a situation in which financial markets no longer functioned. In Norway, it has been appropriate to start winding down the unconventional measures earlier than in other countries:

In recent months, Norges Bank has not supplied liquidity through the currency swap lines or liquidity in foreign currency.

Loans in NOK at long maturities have not been provided since February.

Surplus liquidity in the banking system was increased to more than NOK 100 billion, but is now close to a more normal level. This motivates banks to revert to money market funding.

The swap arrangement involving covered bonds (OMF) in exchange for government securities has made an essential contribution to securing banks' long-term funding. The first signs that the covered bond market was beginning to function appeared in spring. The minimum price in the swap arrangement has been raised by 0.9 percentage point, from NIBOR-0.2 percentage point to NIBOR+0.7 percentage point. Use of the arrangement is currently being phased out.

Norges Bank eased its collateral requirements to enable banks to increase their borrowing in the central bank. This measure is now being reversed.

Norges Bank has also announced that the share of a bank's borrowing facility that can be based on collateral in the form of bank bonds will gradually be reduced. Covered bonds will continue to be eligible as collateral.

Mainland GDP increased in Q2 after two quarters of negative growth. Growth was somewhat higher than expected, reflecting solid growth in public sector demand and private consumption. In September, Norges Bank's regional network contacts reported that activity had edged up in Q3. The main contribution came from industries providing goods and services to households and the public sector.

Despite a moderate rebound in both domestic and international activity, prospects for manufacturing and the building and construction sector remain relatively weak. After falling for a long period, manufacturing production picked up again in July and August.

The decline in new orders and order reserves, in the shipbuilding industry among others, nevertheless indicates a low manufacturing production level in the period ahead. According to the regional network, manufacturing production is expected to remain unchanged over the next half-year. Overall production in the building and construction sector is also expected to remain virtually unchanged, with increased activity in the construction sector underpinning production. Enterprises in the service sector expect production to pick up over the next half-year. Regional network enterprises in the retail sector report that production is rising and expect continued growth ahead.

Chart: Petroleum investment

The petroleum sector is having a stabilising effect on overall demand via new investment, maintenance and operations. Petroleum investment has increased considerably in recent years, but is projected to fall somewhat towards the end of 2009. According to the petroleum investment intentions survey from Statistics Norway, petroleum investment will remain high in 2010. Exploration and production spending appear to be increasing markedly, but the increase will to some extent be offset by reduced spending on goods and services for field development and fields in operation. The change in investment composition will contribute to reducing demand for goods and services from the Norwegian supplier industry.

Several investment projects are planned on the Norwegian continental shelf for the coming years. There are indications that some of the planned investments will require an oil price of around USD 70 per barrel to be profitable. Our projections are based on a rise in the oil price in line with oil futures prices. These prices suggest that the oil price in 2010 and 2011 will be USD 5-10 above the current level. Petroleum investment is therefore projected to be high in the period 2010 – 2012.

Should the global growth outlook deteriorate again, the price of oil may fall markedly. This might lead to a decline in oil investment and also have an adverse impact on the wider Norwegian economy. On the other hand, a fall in oil prices normally results in a depreciation of the krone. Should the krone depreciate for an extended period, inflation may become too high. With lower oil prices, the economic outlook will deteriorate, but the overall effect on inflation of a marked fall in oil prices and a weaker krone is not clear cut.

Chart: Real exchange rates

The sharp decline in activity among trading partners has reduced demand for Norwegian export products. The decline in Norwegian exports has occurred slightly later and been somewhat more moderate than observed in a number of other countries. After a sharp fall in exports in the first half of 2009, foreign trade statistics indicate that traditional merchandise exports have increased somewhat this autumn. Norges Bank's regional network reports that the export industry is expecting approximately unchanged activity over the next half-year.

The cost level in the Norwegian business sector is now about 15 per cent higher than the average for the period since 1970, measured in terms of relative wages in a common currency. Since wage growth is higher in Norway than abroad, relative costs will rise ahead even if the nominal krone exchange rate should remain unchanged. This will put many Norwegian firms in a demanding position in terms of international competition, which may influence location decisions ahead. Export growth is expected to pick up ahead, but at a slower pace than expected market growth abroad.

Chart: Bank credit standards for enterprises and households

The contraction in private investment has been somewhat more moderate in Norway than in a number of other countries over the past year, even though business investment also dropped sharply in Norway. Corporate credit growth is slowing, but Norges Bank's third-quarter bank lending survey indicates that enterprises' access to bank credit has improved and that this tendency will continue in 2009 Q4. At the same time, borrowing in the bond market has become more accessible and less costly. The decline in business investment will probably come to a halt in the course of 2010 as growth recovers, funding conditions improve further and interest rates remain low. Banks' tightening of credit standards has been less pronounced for households than for enterprises. All the banks participating in Norges Bank's lending survey expect credit standards for households to remain unchanged ahead.

Chart: Household credit from domestic sources and house prices

Lower interest rates in the period to summer and easier access to residential mortgage loans have fuelled housing demand. House prices have shown a seasonally adjusted increase of approximately 14 per cent since the trough in November 2008, and the decline in household credit growth has levelled off. Housing investment may start to increase towards the middle of next year.

Chart: Household expectations

Interest rates in Norway are low. This has led to renewed growth in household consumption, and there are prospects that household demand will continue to rise. According to surveys carried out by TNS Gallup and Opinion, household expectations with regard to the outlook ahead are more optimistic now than they were in autumn 2008. In addition, housing wealth has improved as a result of higher house prices, which may underpin growth in consumer spending.

We have limited experience to indicate how the interest rate at the current low level will affect output and prices over time. If growth in household demand proves to be stronger than expected, the interest rate may be raised to a higher level and more rapidly than currently envisaged.

Chart: Structural non-oil deficit and expected return on the Government Pension Fund – Global

Fiscal policy is expansionary this year, and according to the National Budget for 2010, fiscal policy will provide further, albeit milder expansionary impulses to the economy next year. Under the fiscal rule, the government budget deficit should be reduced to about 4 per cent of the capital in the Government Pension Fund – Global when activity in the economy has resumed a normal level. Norges Bank's projections are based on the technical assumption that the structural, non-oil budget deficit in 2011 and 2012 will remain unchanged from the level in 2010. If growth in the Government Pension Fund – Global is lower than in previous years, the deficit will still be more than 4 per cent of the Fund's capital, even after capacity utilisation has risen to a normal level. If economic developments are broadly in line with projections, fiscal policy conducted in accordance with the fiscal rule could result in a lower interest rate and a weaker krone than projected.

Chart: Unemployment (LFS) as a percentage of labour force

Unemployment is high in many countries. Unemployment in Norway has not risen as sharply as previously projected. The number of registered unemployed was 2.8 per cent of the labour force in October, unchanged from September. This is very low compared with other countries.

Chart: Unemployment in Norway

The decline in employment has been less marked than the fall in activity would imply. Unemployment may be low partly because it may have taken time for enterprises to adapt their workforces to the sharp fall in production, and partly because some enterprises have decided to maintain their workforces in anticipation of a pickup in demand. In many sectors, the level of employment is nevertheless high in relation to output, and productivity in the past year has been at its lowest level since 1988.

The projections are based on the assumption that productivity will gradually improve, reducing the pressure on firms' costs somewhat. The projections are also based on improved profitability through an increase in prices. If firms instead reduce employment more rapidly and markedly in order to improve productivity, that will lead to higher unemployment and lower wage and price inflation than projected. The interest rate may then be kept lower for a longer period than currently envisaged in order to ensure that inflation returns to target.

Chart: Annual wage growth and unemployment rate (LFS)

Wage growth is projected to decrease to around 4 per cent in 2009. Weak manufacturing profitability as a result of both a fall in product prices and a low productivity level suggest moderate wage growth ahead. At the same time, wage growth among trading partners is low. As a result, the competitiveness of internationally exposed industries may weaken further in the period ahead. In isolation, this may contribute to curbing wage growth. On the other hand, continued relatively low unemployment in Norway will contribute to pushing up wage growth. Wage growth is projected to increase to 4¼ per cent in 2010, rising further to 4¾ per cent towards the end of the projection period.

Chart: Inflation

The severe cyclical downturn and the decline in commodity prices have resulted in very low consumer price inflation in many countries. The year-on-year change in consumer prices is negative in the US, the euro area, Sweden, Japan and China. Core inflation is more stable, but has also edged down recently. Moderate growth prospects and lower-than-normal capacity utilisation in most advanced economies will lead to low consumer price inflation among our main trading partners throughout the projection period.

The key policy rate was reduced to prevent inflation from falling too far below target and to mitigate the impact of the global downturn on the Norwegian economy. Underlying consumer price inflation in Norway has slowed in recent months to an estimated rate of just below 2½ per cent, reflecting the effects of lower wage growth, reduced capacity utilisation in the Norwegian economy and low inflation abroad. Although the krone depreciation last autumn has pushed up import prices, the effect of the depreciation is probably now waning.

After a period of falling productivity, unit labour costs are high. The projections are based on an increase in firms' margins ahead through an increase in prices. Inflation will nevertheless be curbed by slower wage growth from 2008 and a gradual rise in productivity growth. Somewhat further ahead higher wage growth will push up the rise in prices. The krone exchange rate has appreciated from weak levels. Combined with the fall in prices for imported consumer goods measured in foreign currency, this will push down the rise in prices for consumer goods in the short term.

Consumer price inflation is expected to fall to somewhat below 2 per cent in 2010, and then gradually pick up to around 2.5 per cent towards the end of the projection period.

Chart: Projected key policy rate in baseline scenario with fan chart

Interest rates are low, resulting in renewed growth in household consumption. At the same time, house prices are rising. Over time, household borrowing may surge again and saving may fall. With low productivity, higher corporate costs, growth in household demand and higher capacity utilisation, inflation may gradually become too high. This would indicate that the interest rate should be raised.

On the other hand, a marked increase in the interest rate in Norway and a wider interest rate differential between Norway and other countries may entail a risk of a stronger-than-projected krone, resulting in an inflation level that is too low. This would indicate that the interest rate should not be raised too rapidly.

Monetary policy cannot fine-tune developments in the economy, but it can mitigate the most severe effects when the economy is exposed to shocks. Overall, the outlook and the balance of risks suggest that the key policy rate should be gradually increased in the period ahead.

The projections are uncertain. New information may reveal aspects of economic developments that suggest the Norwegian economy is following a different path than projected. Higher capacity utilisation or a weaker krone may, on the one hand, result in higher-than-projected inflation. On the other hand, inflation may be lower than projected if the krone remains strong or productivity picks up more rapidly. Should the krone appreciate considerably more than projected, the interest rate may be increased to a lesser extent or later than currently envisaged.

The key policy rate should be in the interval 1¼ - 2¼ per cent in the period to the publication of the next Monetary Policy Report on 24 March 2010 unless the Norwegian economy is exposed to new major shocks.

Thank you for your attention.