# The outlook for the Norwegian economy

Address by Governor Svein Gjedrem for Norges Bank's regional network, Region East, Oslo, 25 September 2009.

Please note that 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 23 September and *Monetary Policy Report* 2/09.

It has been a year since financial turbulence developed into a full-blown crisis. The result was the most severe downturn in the global economy since the Second World War. Key rates were set at historically low levels both in Norway and abroad. Government spending has increased considerably to support demand for goods and services.

Global economic activity is now picking up, albeit from a very low level, and unemployment is high. Financial market conditions have improved, although liquidity remains tight in many markets.

The financial crisis eroded confidence in banks, counterparties and contractual partners. Access to export credit came to a halt, international trade slowed sharply and manufacturing sales stalled.

With financial markets improving over the past six months and an increase in the credit supply, global trade is now picking up slightly. Manufacturing output has recently increased in the US, the UK, Japan and many emerging economies, while it continues to fall – albeit at a slower pace – in Sweden and the euro area.

Growth in public demand, stronger confidence in financial markets and low key rates are fuelling investment abroad. Even though the global economic situation now seems to have stabilised, there is still a risk of continued low growth for a fairly long period ahead.

The severe downturn and fall in commodity prices has led to very low or negative consumer price inflation in many countries. Inflation is still moving down and is now negative in for instance the US, the euro area, Sweden, Japan and China. Core inflation is more stable, but has also shown a slight decline recently. The current low level of activity and high unemployment will also act as a brake on inflation in the period ahead.

One characteristic of the crisis was the substantial increase in money market rates. Confidence between banks evaporated. Banks reacted by raising interest rates on loans to businesses and households. They started to turn off the lending tap.

Measures implemented by central banks and governments have had a stabilising effect. The most important markets have also gradually become less disorderly, with less distrust among participants. The risk that issuers of credit will go bankrupt has diminished. Activity in money and bond markets has picked up and fluctuations are less pronounced.

The situation in the interbank market has improved. The spread between money market rates and expected key rates, which is an indicator of risk premiums in the money market, has decreased. Money market premiums in Norway have also fallen.

Equity markets have risen since early 2009. Fluctuations in equity markets are less pronounced but are still wider than before the market turbulence began. Expected corporate earnings have not changed substantially since March 2009. It is likely that the recovery in equity markets primarily reflects a reduction in uncertainty and lower risk premiums.

Oil prices have doubled since the trough in December 2008, reflecting OPEC production cuts and concerns in non-OPEC countries about supply further ahead. In addition, a number of market participants expect that oil demand ahead will increase at a more rapid pace than assumed as global economic activity picks up. Expectations of future economic growth are pushing up oil futures prices.

Oil consumption is now rising in China but has been very low in western economies. OPEC spare production capacity is still increasing and oil inventories in advanced economies are high. Oil prices have nonetheless held up. Keeping large inventories is profitable when oil futures prices are high. However, the scales are easily tipped. If expectations of higher demand deteriorate, futures prices will fall and, in turn, prices for immediate delivery. Large oil inventories may then push down prices even further.

The krone is floating and fluctuates somewhat. The krone tends to appreciate in good times and depreciate when negative shocks occur in the Norwegian economy. Fiscal policy and the petroleum fund mechanism, however, contribute to maintaining the stability of the krone. This is clearly evident when we compare developments in the krone in recent years with the currencies of other open economies that are major commodity exporters, such as Australia and New Zealand.

In recent months, exchange rate fluctuations have moderated and risk appetite among market participants has increased somewhat. The Norwegian krone depreciated considerably in the second half of last year, but has appreciated somewhat since then.

The cost level in the Norwegian business sector, measured by relative wages in a common currency, is now 10 per cent higher than the average in the period we can refer to as the oil age. The level will rise ahead, even if the nominal krone exchange rate should remain unchanged, because wage growth is higher in Norway than abroad. The real exchange rate, measured by developments in consumer prices in a common currency, is in line with a historical average, but may rise ahead as a result of higher inflation in Norway relative to other countries.

Key rates are now close to zero in many countries. Key rate expectations abroad have fallen. Market participants expect a rise in key rates in a number of countries after the turn of the year.

Monetary policy in Norway is oriented towards maintaining low and stable inflation. The operational target is annual consumer price inflation of close to 2.5 per cent over time. The inflation target is an anchor for inflation expectations in the foreign exchange market, for the social partners in connection with wage settlements and for those setting prices for goods and services. In recent years, average inflation has been fairly close to, but somewhat lower than, the target of 2.5 per cent.

Consumer price inflation peaked in October 2008 and has since receded. In the year to August 2009, CPI inflation was 1.9 per cent. Inflation measured by the CPI varies somewhat from month to month, primarily reflecting wide fluctuations in energy prices.

CPIXE inflation shows developments in the consumer price index adjusted for tax changes and excluding temporary changes in energy prices. This indicator provides a more accurate picture of underlying inflation. By this measure, underlying inflation peaked at 3 per cent last autumn, but has since slowed somewhat and was 2.3 per cent in August. Underlying inflation is now below the inflation target. Inflation is slowing as a result of the decline in output and wage growth last year and the beginning of this year and is expected to fall to below 2 per cent in early 2010.

Inflation ahead will depend on how quickly capacity utilisation picks up and by developments in the krone exchange rate. Activity in the Norwegian economy has held up better than expected just a few months ago. Higher capacity utilisation and low productivity growth may result in stronger-than-expected upward pressure on costs and point towards somewhat higher inflation in the medium term.

The financial crisis and the global economic recession have had a substantial impact on the Norwegian economy, and a range of measures have been implemented to mitigate the effects of the crisis. These measures prevented the liquidity crisis from developing into a solvency crisis in the banking sector and a crisis in the real economy in Norway.

Norges Bank has supplied additional liquidity to banks and eased collateral requirements. The Bank has provided loans with longer maturities, used foreign exchange swaps for both USD and EUR to supply krone liquidity and provided loans to Norwegian banks in USD, which Norges Bank can now procure from the Federal Reserve. The key policy rate has been reduced by 4.50 percentage points since 15 October last year to 1.25 per cent. To facilitate banks’ funding, the government has given banks access to liquid government paper in exchange for mortgage-backed securities issued by the banks’ mortgage companies. The Government has also provided increased loans and guarantees to Norwegian export industries, and has raised lending limits for state banks. Folketrygdfondet (the Government Pension Fund – Norway) has also been permitted to increase its purchases of bonds. The authorities have arranged to supply risk capital to Norwegian banks through the Norwegian State Finance Fund to strengthen banks’ solidity. In order to curb the fall in activity in the Norwegian economy, government expenditure will increase by more than 10 per cent in 2009.

The measures implemented by Norges Bank were tailored to a situation in which financial markets no longer functioned. Now, banks and companies are again able to obtain funding in the market. The arrangement whereby banks can exchange covered bonds (OMF) for government securities has made a substantial contribution to securing long-term funding for banks. The first signs that the covered bond market was beginning to reopen became evident in spring. The minimum price in the swap arrangement is therefore now being adjusted to the interest rate that seems to be forming in the market. The arrangement can then be phased out in the course of the autumn.

Over the past year, there has been a substantial need to provide liquidity to banks.

In addition, underlying structural liquidity in the banking system, i.e. liquidity excluding Norges Bank's liquidity operations, has been negative in recent years.

Structural liquidity is influenced by ingoing and outgoing payments to and from the Government's account in Norges Bank and is expected to increase ahead, primarily because the Government largely finances lending to state banks, payments to the Norwegian State Bond Fund and the Norwegian State Finance Fund by drawing down deposits in Norges Bank. Banking system demand for loans from Norges Bank will then decrease considerably.

In most countries, the financial crisis led to a crisis in the real economy. Fiscal policy measures were gradually implemented as it became clear how strongly the financial crisis was affecting economic activity levels. Many governments have accumulated substantial debt. With few exceptions, all the advanced economies were already in a net debt position and many are now facing funding problems related to an aging population. If the global economy is to recover from the crisis, government debt must be stabilised fairly soon in order to prevent a string of crises in state finances. Norway is in a unique position due to government petroleum revenues.

Monetary and fiscal policy have stimulated domestic demand and output. Growth in mainland GDP was higher in the second quarter than projected in the June *Monetary Policy Report*. Household consumption seems to be picking up again.

Petroleum industry activity has also had a stabilising effect on the Norwegian economy. There are plans to develop a number of oil fields on the Norwegian continental shelf in the years ahead, but it is likely that these investments will require an oil price of more than USD 60–70 per barrel to be profitable.

The events of September 2009 spread rapidly to the firms in Norges Bank's regional network. In August 2009, manufacturing enterprises reported that growth would hold up. In November, the turnaround was described as a "heart attack".

Norges Bank established its regional network in 2002. Regular interviews provide information about enterprises' assessment of the economic outlook before other official statistics are available. This information is therefore an important part of the decision-making basis in the formulation of monetary policy.

Statistics Norway's quarterly national accounts are available about 50 days after the end of the quarter. The regional network provides figures for the same quarter far earlier. In 2008, the regional network was able to provide clear evidence that mainland output fell markedly in the fourth quarter as early as December of the same year. National accounts figures for the fourth quarter were published more than two months later, on 19 February 2009.

Employment in Norway has held up well through the downturn. It appears that unemployment will be considerably lower than expected. Seasonally adjusted registered unemployment was 2.9 per cent in August. Over the past year, the level of unemployment has risen most in the counties of Aust-Agder, Sør-Trøndelag, Østfold and Vestfold and least in Sogn, Akershus and Finnmark. Unemployment is highest in Oslo, at 3.9 per cent in August. Unemployment may be low because firms have chosen to retain their employees. Perhaps firms are opting to keep a certain labour reserve because of recruitment problems and high costs experienced during the previous cyclical turnaround. Higher government expenditure has contributed to holding up public sector employment. Unemployment may move up if global developments deteriorate and have a stronger impact on output in Norway.

Between 1000 and 2000 new jobseekers from other countries are still being registered each month, even though work permits were no longer required for nationals from new EU countries as of 1 May for work lasting less than three months. The level of registered work permits, however, seems to have stabilised over the past year.

Inward migration flows are lower than in the period to summer 2008, but have not come to a complete halt.

In 2009, the loss of confidence among banks also affected household mortgage financing. Banks no longer provided bridging loans. Housing turnover fell, but has now picked up again.

House prices are rising after a sharp fall in the second half of 2008. Last autumn it was important to restart the housing market, which will also gradually provide the basis for a potential recovery in residential construction. However, the revival in house prices is not a positive development. The level of house prices in Norway is very high and the additional rise that has now occurred will only increase the potential fall.

Developments in Norway, and to an even greater extent in other countries, show that economic policy instruments are not perfect. The interplay between credit and property prices in particular poses challenges.

Interest rate setting influences this interplay only indirectly. The interest rate rises in good times when inflation is expected to increase and falls when growth and inflation moderate. The interest rate is an approximate instrument, which can be used to keep inflation in check over time and thereby stabilise output and employment.

In a small, open economy such as Norway's, the exchange rate is important for inflation and the level of activity. There is therefore little leeway for setting the interest rate specifically with a view to influencing property markets and credit growth. Attempts to tighten monetary policy in the growth period from 2003 to 2008 would, for example, have resulted in higher capital inflows, a noticeably stronger krone and a decline in manufacturing, even lower inflation, higher growth in real wages and more foreign currency loans to households and enterprises. The rise in credit and house prices would probably not have been affected to any extent. In addition to housing market euphoria, the Norwegian krone would have been considerably overvalued for a period.
According to Norge Bank's bank lending survey, banks continued to tighten credit standards for enterprises while credit standards for households remained virtually unchanged in 2009

Q2. Banks expect approximately unchanged credit standards for both enterprises and households in 2009 Q3.

Banks reported a further fall in credit demand among non-financial corporations in 2009 Q2. Credit demand in the enterprise sector is expected to stabilise in Q3. Household credit demand was approximately unchanged in Q2, while banks expect increased household credit demand ahead.

Financial market turbulence since summer 2007 resulted in a sharp increase in interest rates, reaching a peak in 2009 Q1. Premiums have decreased substantially since then, but are perhaps not yet fully normalised.

Bank lending rates on loans to enterprises averaged 8 per cent at their highest in 2008 and have now moved down to 4¾ per cent, although margins have also increased here.

Norges Bank's Executive Board decided in June that the key policy rate should be in the interval ¾ - 1¾ per cent in the period to the publication of the next *Monetary Policy Report* on 28 October 2009, unless the Norwegian economy is exposed to new major shocks.

In the assessment forming the basis for its monetary policy decision of 23 September, the Executive Board placed emphasis on underlying inflation, which is now below the inflation target. The krone has appreciated and will, in conjunction with continued low imported inflation, contribute to keeping inflation below target in the year ahead. This suggests that the key policy rate should be kept low for a period ahead.

Growth in the Norwegian economy has picked up at a more rapid pace than was expected a few months ago. High activity in the oil industry and monetary and fiscal policy measures have contributed to supporting demand for goods and services. Employment is stable and it appears that unemployment will be considerably lower than expected, despite the decline in manufacturing and the building and construction industry. Low interest rates are contributing to renewed growth in household consumption. Higher capacity utilisation and low productivity growth may increase upward pressure on costs, pointing towards somewhat higher inflation and suggesting that the key policy rate should be raised earlier than projected in the June *Monetary Policy Repor*t.

On balance, it was appropriate to keep the key policy rate unchanged at this meeting, although the Executive Board considered the alternative of increasing the key policy rate.

Thank you for your attention.