The economic outlook for Norway

Address by Governor Svein Gjedrem for Norges Bank's regional network, Region East, 19 November 2008.

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 29 October and Monetary Policy Report 3/08.

Financial market imbalances

The first signs of an emerging crisis in financial markets came into evidence in early 2007. The crisis intensified in August last year and entered a new phase in March this year when the US authorities had to bail out the investment bank Bear Stearns. What began as isolated losses in a small segment of the US housing market gradually had substantial spillover effects on the global financial system.

The crisis took a new and dramatic turn when Lehman Brothers, the fourth largest US bank, filed for bankruptcy on 15 September this year. The failure contributed to a weakening of confidence between financial market participants, and many financial markets abroad, but also in Norway, almost stopped functioning. Confidence was further eroded when the crisis spread to US commercial and savings banks. Among other things, bondholders suffered losses after the largest US savings bank – Washington Mutual – was split up and partially acquired by JPMorgan Chase in the wake of heavy mortgage losses. On 17 September, American International Group (AIG), the largest US insurance company, had to rely on an emergency loan from the Federal Reserve. The company played a key role in the credit default insurance market.

The financial crisis has heightened in several European countries. Banks in Belgium, Denmark, France, the Netherlands, the UK, Sweden and Germany have been taken over by the government or other financial institutions. In Iceland, the authorities took over the three largest banks and are now unwinding their international operations. The crisis at these banks prompted a flight from Iceland's national currency which, combined with a property market crash, has triggered a sharp recession.

In Norway, the effects of the financial crisis have also occurred more rapidly and become more pronounced than the outlook seemed to imply only recently. Norway is still in a better position than most countries. Capacity utilisation in the Norwegian economy has been very high. The surplus on current account is considerable and government finances are solid. Norwegian banks have limited exposures to international securities. They have suffered only small losses and recorded solid earnings in recent years. Furthermore, the Norwegian banking system is not large relative to the size of the Norwegian economy.

In response to the uncertain environment, banks abroad and at home are reluctant to lend to each other and are tightening their credit standards. Credit channels are drying up. Money market rates have increased markedly, and to levels substantially higher than central bank key rates. The fallout has been particularly pronounced in the US, but European interest rates have also risen sharply. The flow of dollars among banks has seized up at times.

Other than central bank measures to supply liquidity to banking systems, the authorities in the US and Europe first approached the financial crisis as a succession of problems at individual institutions. In the US, a general package was adopted by Congress on Friday 3 October. USD 700 billion was allocated for purchasing illiquid assets from financial institutions. On 8 October, the UK government announced a number of measures to stabilise financial markets, but with emphasis on providing risk capital. Euro area countries followed suit and on 12 October agreed to take similar action. On 12 November, the strategy for the US crisis package of USD 700 billion was changed to provide the authorities with the scope to inject capital into banks and other financial institutions.

There is unusually high uncertainty surrounding economic developments ahead. This is reflected in equity markets among other things. Since spring, stock indices have plummeted both abroad and on the Oslo Stock Exchange. The Oslo Stock Exchange has declined by more than 50 per cent since the peak in May.

On 8 October, the central banks in the US, the UK, Canada, the euro area, Switzerland and Sweden implemented coordinated interest rate cuts. The central bank of China also reduced its key rate. On 29 October, the Federal Reserve reduced its key rate by a further 0.5 percentage point. On 6 November, the European Central Bank and the Bank of England reduced their key rates by 0.5 percentage point and 1.5 percentage points, respectively. Market participants expect key rates to be reduced further among most of our trading partners. Norges Bank reduced its key policy rate by a total of 1 percentage point to 4.75 per cent.

Norwegian money market rates increased markedly as a result of risk premiums abroad spilling over into the Norwegian market. The eurodollar market has been a widely used source of financing for Norwegian banks. Dollars in this market are used to procure NOK liquidity and to redistribute liquidity among banks. Banks borrow in US dollars and then swap them for NOK.

The conditions in financial markets have improved somewhat recently, but access to credit is still limited and risk premiums are high. Premiums are expected to edge down in the coming quarters, but market participants believe that it will take time to restore confidence in banks.

Monetary policy influences the economy through several channels, often referred to as the monetary policy transmission mechanism. The relationship between Norges Bank's key policy rate and the effects on activity and inflation has been impaired by money market conditions. The transmission mechanism is not functioning as previously.

Money markets have become highly segmented. There is limited turnover and at times it is difficult for foreign operators to satisfy their need for NOK liquidity. Small Norwegian banks that previously borrowed from large banks are now turning directly to Norges Bank for loans. In this period the central bank in Norway, as in other countries, has actually become a marketplace, and the only marketplace, for banks.

With a view to curbing the effects of the turbulence Norges Bank has implemented a range of measures to boost liquidity in the banking system. Norges Bank has provided loans with maturities that are longer than normal and has expanded the list of eligible bank collateral for loans. The Storting (Norwegian parliament) has adopted a package providing for an arrangement whereby banks can exchange safe, but today illiquid residential mortgage-backed bonds for highly liquid government securities.

Higher money market premiums have led to higher interest rates on loans to both households and firms. As most residential mortgages in Norway are floating-rate loans, money market rates have a greater bearing on Norwegian households than households in most other European countries. Liquidity measures in Norway and other countries have resulted in some decline in premiums. Combined with a reduction in Norges Bank's key policy rate, this has prompted several banks to reduce their deposit and lending rates and to cancel previously announced increases. Interest rates have now fallen back to levels observed before the collapse of Lehman Brothers.

Oil prices have fallen by more than USD 80 after peaking in July. Growth in oil demand has fallen as a result of weaker economic developments. Moreover, the fall in demand probably reflects adaptations among households and businesses in the wake of the sharp rise in oil prices up to summer. A stronger dollar, heightened uncertainty and reduced willingness and ability to take risk among financial investors in the futures market for oil may also have contributed to the fall in oil prices.

Commodity prices have dropped sharply since summer. Lower metal prices reflect lower global growth prospects. It may almost seem as though that there has been a bubble in oil and commodity markets which has now burst.

The fall in energy and commodity price has resulted in a weakening of Norway's terms of trade.

Foreign exchange markets have also been volatile. Interest among investors has shifted away from carry trade to more liquid currencies or own currencies. Since June, low-interest currencies, such as the Japanese yen and the Swiss franc, have appreciated while high-interest currencies, such as the Australian and New Zealand dollar, have depreciated. The US dollar has appreciated from low levels.

The krone exchange rate has depreciated since end-June. This partly reflects the financial market turmoil. Low risk willingness had induced investors to scale back their positions in less liquid currencies such as the Norwegian krone. The fall in the price of oil and other commodities has probably also contributed somewhat to the depreciation. The krone exchange rate is expected to appreciate gradually when financial market conditions improve. The fall in terms of trade may nevertheless imply that the krone exchange rate does not return to previous heights. A weaker krone may contribute to underpinning profitability in the export sector. Cost competitiveness in manufacturing has improved in recent quarters.

Effects on output, employment and inflation
The financial turbulence has weakened the outlook for investment and consumption in many regions of the world. Against the backdrop of losses and structural changes in the financial

sector, many large financial institutions will for a long period ahead seek to increase their interest rate margins, reduce lending and risk. Lending standards have been tightened, particularly in the US and the UK, but also in the euro area. Output has fallen in the US, the euro area and the UK, and growth may be negative in the coming quarters.

In emerging economies, the cyclical downturn has also come into growing evidence. In several countries, economic growth is being pulled down by both lower market growth in other countries and reduced access to credit.

Monetary policy in Norway is oriented towards annual consumer price inflation of close to 2.5 per cent over time. In recent years, inflation has on average been somewhat lower, but fairly close to 2.5 per cent. Low and stable inflation is the most important contribution monetary policy can make to sound economic developments, providing firms and households with an anchor for inflation expectations. Norges Bank operates a flexible inflation targeting regime so that weight is given to both variability in inflation and variability in output and employment when setting interest rates.

The Norwegian economy has in general exhibited solid growth since the beginning of the 1990s, although with a mild setback in 2002 and 2003. Over the past four years, the mainland economy has been in a sharp upturn, with annual growth averaging well over 4 per cent and particularly vigorous growth in 2007. Growth is now slowing markedly in the Norwegian economy. Household consumption has stagnated and house prices are falling.

Growth in the Norwegian economy has slowed, while inflation has accelerated. In October, the year-on-year rise in the consumer price index (CPI) was 5.5 per cent. Electricity prices rose sharply through summer after unusually low prices last year.

Underlying inflation has also picked up. Inflation adjusted for tax changes and excluding temporary changes in energy prices (CPIXE) was 3½ per cent in October. Wage growth is markedly higher and productivity growth has slowed considerably. The high rate of cost inflation has led to a faster rise in prices for domestically produced goods and services. Prices for imported consumer goods are no longer falling and are now on the rise. The slowdown in the real economy is expected to start pushing down inflation towards next summer. Higher unemployment and weaker corporate profitability will probably lead to low pay increases in the wage negotiations next spring. Energy price inflation will also be considerable lower ahead.

In August, the enterprises in Norges Bank's regional network noted that there had been a shift in sentiment in the Norwegian economy. An extra round of calls to some contacts in October indicated that the outlook had worsened since August.

The latest reports from enterprises in Region East indicate that demand has declined since summer, with a further drop in September and October. Customers are responding to tighter lending conditions by postponing projects. The changes have occurred rapidly, and there is now considerable uncertainty among our contacts in this region with regard to developments over the next six months. The majority of the enterprises report that they will reduce investment. Many are considering workforce reductions as an alternative if the situation does not change in the New Year. The majority also envisage lower wage and price inflation ahead.

In the past year, unemployment has been as low as in the mid-1980s. Seasonally adjusted registered unemployment was 1.8 per cent in October. The enterprises in Norges Bank's regional network are expecting some reduction in the workforce ahead. There has been a slight increase in layoffs. Going forward, enterprises will probably adjust the workforce to lower output growth and reduce the use of overtime.

After a long period of high housing investment and rising prices, activity in the housing market is now slowing. Tighter credit conditions are amplifying the fall in house prices. Even though there are variations across regions, the trend in house prices is the same – from a more moderate rise at the beginning 2007 to a clear decline at the beginning of 2008.

Norges Bank's lending survey for the third quarter shows that banks are tightening credit standards for households. Banks announced further tightening ahead. Owing to growing turmoil and liquidity shortages in financial markets, banks have raised their requirements with regard to collateral and borrowers' debt-servicing capacity. Growth in household credit has slowed in recent months.

House price developments affect building starts, which have decreased in the past year. The decline is sharpest for residential building starts. In October, enterprises in Norges Bank's regional network indicated a very low level of housing starts in the period ahead. Order reserves for commercial buildings and holiday homes are high, however. Commercial construction is largely financed by loans, and may therefore be affected by changes in interest rate and credit conditions. Enterprises in Norges Bank's regional network report that commercial building starts have declined in recent months.

Household saving has picked up. Household income accounts show that the savings ratio excluding share dividends has risen, but is still very low and negative. Household borrowing requirements have also decreased somewhat. (Household net lending has picked up slightly.) The financial market crisis has led to higher borrowing costs for banks and has kept bank lending rates at a higher level than developments in the key rate would imply. Households probably need to build up financial buffers and reduce debt, which will in turn weigh down on growth in private consumption ahead.

Growth in spending on goods stalled last autumn. There has been a considerable drop in car sales in particular. Norges Bank's regional network also reports a decline in demand for goods related to moving home, such as white and brown goods and refurbishing equipment. Growth in consumption is expected to be very low for a period ahead, but growth in private consumption may pick up again towards the end of next year.

Growth in mainland investment has been strong in recent years, but is now moderating. According to the national accounts, corporate investment was still on the rise in the first half of the year, but there was a considerable decline in housing investment. Falling housing starts, reduced order reserves and assessments from the enterprises in Norges Bank's regional network indicate that housing investment will continue to show a pronounced fall next year. Gross investment is expected to decline by 14 per cent on an annual basis in 2009, remain at a low level in 2010 before picking up in 2011.

Even though the krone depreciation is curbing the impact, the global downturn is expected to result in lower growth in Norwegian exports.

The high level of petroleum investment was an important driving force during the economic upturn, and petroleum investment is expected to remain high in the years ahead. Some investments may be postponed if oil prices fall permanently below USD 60-70 per barrel, especially small investments and upgrades of fields in operation. Exploration activity may also be cut back. Large field development projects are probably being affected only to a limited extent, while small companies and smaller investment projects may be adversely affected by the reduced availability of credit.

Growth in the Norwegian economy slowed markedly in the first half of this year. The effects of the financial crisis will most probably be greater than envisaged only recently. The slowdown in the Norwegian economy seems to be occurring rapidly and to be pronounced. Mainland growth is projected to be very low in 2009, then recover in 2010 and 2011. Petroleum investment will buoy up activity. The central government budget will also boost growth in public demand for goods and services.

In the *Monetary Policy Report*, the results of monetary policy assessments are illustrated in a chart showing projections for the interest rate, inflation and capacity utilisation in the economy. We have illustrated the uncertainty surrounding our projections using fan charts. The width of the fan charts is based on historical disturbances, and therefore expresses the average that covers periods of high and low uncertainty. There is now unusually high uncertainty surrounding future developments in inflation and output and hence surrounding interest rate developments. It is difficult to determine probabilities of different outcomes of the ongoing financial crisis. In such decision-making situations it may be appropriate to implement measures that can reduce the uncertainty and stave off particularly adverse outcomes for the economy. This now implies a more active monetary policy than normal, both in interest rate setting and through liquidity policy measures. When setting the key policy rate, we must also take account of developments in premiums in money market rates, other bank funding costs and bank deposit and lending rates.

Weight has been given to moving forward the reduction in the key policy rate so that lending rates for households and firms can gradually be reduced. Norwegian banks, households and some businesses have increased their borrowings considerably in recent years. It is important that the necessary deleveraging does not take place too abruptly. Lower interest rates, combined with liquidity measures, may curb the impact of the financial crisis on output and inflation.

At the monetary policy meeting on 29 October, Norges Bank's Executive Board decided to reduce the key policy rate by 0.50 percentage point to 4.75 per cent. The Executive Board's assessment was that the key policy rate may lie in the interval 4-5 per cent in the period to the publication of the next *Monetary Policy Report* in March 2009, unless the Norwegian economy is exposed to new major shocks.

Thank you for your attention!