Monetary policy and the cyclical situation

Speech by Mr. Jarle Bergo, Deputy Governor of Norges Bank, Kapp, 23 November 2005

Please note that the text below may differ slightly from the actual presentation. The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 2 November, Inflation Report 3/05 and on previous speeches.

The economic situation

The cyclical upturn in the Norwegian economy continues. Overall capacity utilisation in the economy has increased. After a period of very low consumer price inflation, there are prospects that inflation will again rise at a faster pace. Interest-rate setting since this spring has been oriented towards a gradual increase in the interest rate - in small, not too frequent steps - towards a more normal level. On the basis of the analysis in *Inflation Report* 3/05, this strategy still appears to provide a reasonable balance between the objectives of monetary policy.

The reduction in Norges Bank's key rate through 2003 and into 2004 resulted in low interest rates. At the beginning of the recovery, falling interest rates and expectations of low real interest rates ahead fuelled private consumption.

A weaker krone exchange rate and the international recovery stimulated traditional merchandise exports. Moreover, fixed investment in the petroleum sector has expanded sharply, which has led to rising demand for goods and services supplied by mainland enterprises. Mainland fixed investment also picked up after a period.

Since the recovery started, quarter-on-quarter mainland GDP growth has averaged 3½ per cent annualised. Growth has been steady. The economic upturn has continued this year. On balance, demand is expected to remain relatively high in the near term. Expectations of continued low albeit rising interest rates and real income growth should support growth in household consumption and fixed investment ahead. Brisk investment growth in the petroleum industry, moderate wage growth and high profitability in many enterprises suggest further investment growth in the mainland enterprise sector. The economic upturn is now broadly based.

In manufacturing, the order backlog is at a record-high level, which implies continued production growth over the next quarters. Statistics Norway's business tendency survey for manufacturing points in the same direction. Activity has remained buoyant in the construction sector for a long period. New orders in this industry are rising, which points to a further increase in production. Growth in turnover in property management and commercial services has increased to a high level. Higher activity in goods-producing industries and the prospect of solid growth in household demand provide a basis for continued growth in service industries. However, cost levels in the Norwegian business sector are high. This challenge may become more visible when the upturn slows.

The output gap is a measure that expresses our assessment of total capacity utilisation in the economy. The output gap is defined as the percentage difference between actual output and potential output. Potential output indicates the level of output that is consistent with price and cost stability. The estimate for the output gap is uncertain, partly because the level of potential output is unobservable and must be estimated. Since official statistics on overall activity in the economy are not available immediately and are subsequently revised, the level of actual output will be uncertain.

Our overall assessment is that capacity utilisation has picked up over the past two years and is now slightly higher than normal. In our estimation of the output gap, the result of technical calculations is compared with other sources of information about capacity utilisation in the economy. Information from Norges Bank's regional network may indicate that overall mainland capacity utilisation is close to a normal level. However, there are signs of bottlenecks in production in some sectors of the economy. For example, capacity utilisation in the construction sector is very high, particularly in the southwest region of the country. There are signs of some skills shortages in the construction industry, in manufacturing and in some service industries.

Even though growth in the Norwegian economy has been high for a long period, substantial labour shortages have not yet emerged in the economy as a whole. The increase in the number of employed has been relatively low throughout the upturn. Employment has shown a smaller rise than in previous cyclical upturns in the 1980s and 1990s. Both official statistics and Norges Bank's regional network indicate that many enterprises have been reluctant to recruit new employees. There are now some signs of a change in this attitude. Growth in LFS employment has picked up in recent months. A larger share of the contacts in our regional network are considering increasing their workforces and fewer are considering a reduction.

In the first quarters of the current upturn productivity growth was high, measured as GDP per person-hour. The number of person-hours worked gradually increased substantially, particularly because of the sharp fall in sickness absence through 2004. However, the use of overtime has also increased to a fairly high level. This may indicate that the use of resources is somewhat higher than implied in isolation by the level of employment and unemployment. Nor do wage developments point to any substantial pressures. So far, there are few signs of an acceleration in real wage growth.

The use of foreign labour has increased in the year that has passed since the enlargement of the EU. The scope is relatively moderate, but appears nonetheless to have reduced bottleneck tendencies in some industries where demand has increased sharply. Traditionally, many workers from our neighbouring countries have contributed when the labour market in Norway has been tight. In 2001, close to 30 000 persons resident in Sweden were employed in Norway for all or part of the year. Swedes who have registered as residents in Norway come in addition.

An increased supply of labour from new EU member states to Norwegian enterprises will result in a higher-than-normal increase in potential output for a period.

Many of the foreign workers work for a shorter period in Norway without being employed in a Norwegian enterprise. Examples include foreign contractors and self-employed in the construction industry who carry out various building projects in Norway, as well as others who carry out other types of projects. Aker Kværner, for example, has contracted 300 consultants based in India to work on the Ormen Lange project in northwest Norway. An increase in the use of these short-term contracts will appear as an increase in Norway's service imports, and increases the supply of goods and services without drawing on domestic resources.

The latest Directorate of Labour figures show that seasonally adjusted unemployment was 3.4 per cent in October. Statistics Norway's Labour Force Survey (LFS), however, presents a somewhat weaker picture of unemployment. Registered unemployment is on the decline in all regions. The fall in unemployment has been relatively moderate in Region Inland, although this is partly because the level of unemployment was already low.

As I mentioned earlier, the reports from Norges Bank's regional network provide important information for Norges Bank's analysis of the Norwegian economy. Information about the state of the Norwegian economy is available earlier than information provided by official statistics, and it is useful to have closer contact with business and industry throughout the country.

The main impression from the latest round of interviews is that demand and output are rising in all sectors. The market outlook is reported to be positive, and the enterprises Norges Bank has contacted indicate that growth will be at least as strong six months ahead as it is now. The figures show that capacity utilisation in the business sector is gradually increasing. Some petroleum-related activities and parts of the construction sector are experiencing capacity problems, but so far, the pressure on factors of production does not seem to be particularly high in other industries. All industries report plans for moderate to solid growth in investment. In tandem with the economic upturn, employment is also rising throughout the private sector, with in general little evidence of wage pressures.

Developments in Hedmark and Oppland counties are largely consistent with the overall picture for Norway. The industry structure in Hedmark and Oppland does not differ substantially in most sectors from the country as a whole. The exception is the primary industries, which play a far more important role in these two counties than in the rest of the country. The largest farming areas in Norway are to be found in Hedmark and Oppland, and employment is high in the primary industries. The share employed in the public sector is also somewhat higher than in Norway as a whole. Unemployment has also been markedly lower in the inland region than in most other regions in recent years.

According to the most recent reports, the economic situation in the region is favourable. Participating companies report rising employment and solid growth in all industries. In retail trade and in the construction sector, activity is brisk and increasing, with a somewhat wait-and-see approach to future developments. Growth in manufacturing has slowed slightly, but is likely to stabilise. Investment is rising in all sectors. Enterprises in the region envisage a slight rise in prices in the period ahead.

Inflation has edged up since the beginning of 2004. In October, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) was 1.2 per cent. Adjusted for the estimated direct effect of the interest rate fall on house rents, the rise in prices is estimated at 1.3 per cent in October. Total consumer prices (CPI) rose by 1.8 per cent in the same period.

Prices for domestically produced goods and services rose by 2.0 per cent in the twelve months to October this year. The rise in prices for domestically produced consumer goods exposed to international competition has been very low this year. In October, prices for these goods were 0.2 per cent higher than in the same month one year earlier. This probably reflects the strong competition that Norwegian producers of consumer goods encounter from international operators. At the same time, domestic demand is being stimulated by low interest rates, and in some industries capacity utilisation is providing a basis for higher margins. Service prices, which showed little rise last year, have increased again this year. In many industries, including the airline industry, where price competition is strong, low profitability has led to an increase in prices. High oil prices have also resulted in increased prices, for example for transport services.

On the basis of the pay increases agreed upon in this year's wage settlement, combined with the estimates for wage drift and wage carry-over, annual wage growth is projected at around 3½ per cent this year. This is somewhat lower than the average for the past ten years. The relatively low level of inflation implies, however, that real wage growth is in line with the average for the past ten years.

Prices for imported consumer goods are still falling from the level prevailing one year earlier. Sharply rising production capacity in the world economy as a result of high investment levels in many low-cost countries has led to subdued price increases for many internationally traded goods. The dismantling of trade barriers has also boosted imports of consumer goods from countries with low cost levels. For example, clothing imports from these areas have increased markedly in the past few years. This has contributed to a significant fall in clothing prices.

Clothing imports are not the only imports from low-cost countries that have exhibited strong growth. The share of our imports from these countries also seems to be rising for other goods, such as audiovisual equipment, furniture and white goods. This is pushing down the rise in prices for imported consumer goods.

Structural changes in world trade have been important for the Norwegian economy, not least for the rise in prices for imported goods and services. We assume that the shift in imports towards low-cost countries will continue, with an attendant dampening effect on inflation. This effect will be countered by the increase in prices for oil and other commodities that is expected to result in a somewhat higher rise in producer and export prices among our trading partners.

Monetary policy and the economic outlook in Norway and abroad

Monetary policy in Norway is oriented towards low and stable inflation, with annual consumer price inflation of close to 2.5 per cent over time. This is also the most important contribution monetary policy can make to sound economic developments in the long term. Low and stable inflation provides the economy with a nominal anchor. This contributes to predictability for those who take decisions about saving and investment today, although the result of those decisions depends on how the economy develops in the future. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment. Flexible inflation targeting builds a bridge between the long-term objective of monetary policy, which is to keep inflation on target and provide an anchor for inflation expectations, and the more short-term objective of stability in the real economy.

Monetary policy influences the economy with long and variable lags. This means we must look ahead when setting interest rates. I would therefore like to comment briefly on some international developments that are important to the Norwegian economy and the assumptions concerning developments in Norway on which Norges Bank's assessments are based. The developments I will be describing are based on the analysis in *Inflation Report* 3/05 and the Executive Board's assessments following the monetary policy meeting at the beginning of November.

Prospects for global growth are still favourable. Among many of our trading partners, economic policy is oriented towards increasing activity. This will to some extent counteract the dampening effect of high oil prices. Domestic demand among main trading partners such as the euro area and Sweden is expected to edge up somewhat next year. For our trading partners as a whole, economic growth is expected to increase somewhat from 2005 to 2006. In the years ahead GDP for an average of our trading partners is expected to grow by around 2½ per cent.

Very high growth in demand for oil contributed to rising oil prices in 2004 and the first half of 2005. Oil prices have also been influenced by international incidents, such as terror actions and Hurricanes Katrina and Rita that resulted in extensive damage both to installations that produce crude oil and natural gas in the Gulf of Mexico and to refineries in the area. Last summer, North Sea oil prices (Brent Blend) generally ranged between USD 55-60 per barrel, and in August prices were approaching USD 70 per barrel. Oil futures have also increased. Since the beginning of October, oil prices have fallen back somewhat, and the price of North Sea oil has been below USD 55 per barrel for the past few days. The price fall primarily reflects slower growth in oil demand in many markets. This may be a sign that oil prices have reached a limit in terms of how high prices can be without having a noticeable impact on oil demand and other economic activity.

Rising or persistently high oil prices may gradually dampen growth among our most important trading partners. The slowdown may occur gradually, and will not necessarily be particularly pronounced.

It appears that high oil prices are resulting in somewhat higher consumer price inflation among several of our trading partners than assumed earlier. There are clear signs that consumer prices are increasing more rapidly in the US, the UK and to a certain extent in the euro area.

So far, high energy prices have had a limited impact on other consumer prices. Core inflation in the US and the euro area has shown little increase so far. In the UK, however, core inflation is now more than 1.5 per cent and seems to be on the rise. So far, moderate wage growth in both Europe and the US suggests that employees have not been compensated for the rise in energy prices. If the increase in oil prices is perceived as long-lasting, this may result in higher inflation expectations, higher wage demands and a more pronounced pass-through to other prices.

Over the past few months, key rates have been raised in the US, Canada and New Zealand, while the UK key rate has been reduced by 0.25 percentage point. Key rates remain low among many of our trading partners. Market participants seem to expect a gradual increase in key rates in the period ahead, and at a somewhat faster pace than expected last summer. Towards the end of 2006, key rates in the US and the UK are expected to be around 4½ per cent. For the euro area and Sweden, key rates are expected to be considerably lower, at a little less than 2¾ per cent and 2½ per cent respectively.

In recent months, global long-term interest rates have also edged up again somewhat. This reflects stronger inflationary impulses as a result of high energy prices. Market participants' long-term inflation expectations, measured as the difference between nominal and real government bond yields, have shown a small increase since last summer.

Low interest rates and expectations of continued low real interest rates are sustaining the cyclical upturn in Norway. In addition to buoyant growth in other countries, terms-of-trade gains and higher demand in the petroleum industry are important driving forces behind the upturn. Capacity utilisation in the economy has picked up and is now probably higher than its normal level.

High oil prices have a different impact in Norway than in oil-importing countries. A rise in oil prices improves our terms of trade. Moreover, as a result of persistently high oil prices and expectations that oil prices will remain high, investment in the petroleum sector may reach record levels this year. The investment intentions survey for the petroleum sector points to very high growth.

In our projections, we have assumed that fiscal policy will have a cyclically neutral impact on the economy next year. For 2007, our projections are based on the assumption that fiscal policy will be consistent with the fiscal rule, while fiscal policy for 2008 will provide some stimulus to total demand and output, although somewhat less than a mechanical application of the fiscal rule would imply. High oil prices will particularly be reflected in a sharp rise in the Petroleum Fund's total capital.

After a period of very low consumer price inflation, there are prospects that inflation will again rise at a faster pace. Nevertheless, there are considerable differences in the rise in prices across goods and services. On the one hand, Norway is still benefiting from the growing liberalisation of world trade. Imports from countries where the price level is lower than in Norway are increasing, resulting in a fall in prices for a number of consumer goods. On the other hand, higher production in large countries such as China and India has led to higher prices for energy products. As a result, the overall rise in consumer prices has edged up both at home and abroad.

The projections in the *Inflation Report* are based on an interest rate path that in the Executive Board's assessment provides a reasonable balance between the objectives of monetary policy. Previously, we based our analysis on various technical assumptions concerning future interest rates. One such assumption was market interest rate expectations. As from *Inflation Report* 3/05, we now base our projections on an interest rate path that we consider reasonable. This gives Norges Bank more active ownership of the projections that are presented and of the uncertainty we believe surrounds these projections.

The arguments favouring a very low interest rate in Norway are to some extent less relevant. The outlook and analyses suggest a gradual increase in the interest rate towards a more normal level, but we expect the adjustment to occur in small, not too frequent steps.

Output growth is high and may in isolation suggest a more rapid increase in the interest rate ahead. This would reduce the risk of bottlenecks in the economy with rising cost inflation and continued debt build-up. On the other hand, raising the interest rate more rapidly would increase the risk of a stronger krone, which could prevent inflation from reaching the target of 2.5 per cent.

The projections indicate that the interest rate will rise by about 1 percentage point in the course of the next year. This is consistent with expectations in the money and foreign exchange market. At the 2-3 year horizon, we expect a further, gradual rise in the interest rate. Norges Bank's projected interest rate slightly further ahead is somewhat higher than forward rates in the financial market, but market rates in Norway and other countries may have been pushed down by extraordinary factors in the world economy.

Norges Bank has assumed that money market rates among our trading partners will also increase gradually over the next three years. The interest rate path in Norway and abroad may be consistent with an approximately unchanged krone exchange rate.

With interest rate developments as outlined above, CPI-ATE inflation is projected to increase gradually from about 1½ per cent today to close to 2 per cent at the beginning of 2007. There are prospects that inflation will increase further and reach the target of 2.5 per cent in the second half of 2008. With a gradual reduction in unemployment, Norges Bank expects wage growth to pick up after a period. At the same time, profit margins are expected to edge up in pace with rising demand and capacity utilisation. With continued low interest rates, output growth is likely to be above trend again next year. Even though a gradual increase in the interest rate will result in somewhat weaker growth impulses after a period, monetary policy will still be expansionary.

The output gap, which is a measure of capacity utilisation in the economy, is estimated to be positive this year and increase to about 1 per cent in 2006. A gradual increase in the interest rate towards a more normal level will probably result in lower growth in demand for goods and services after a period. Growth in household disposable income will probably be reduced, and growth in housing investment will slow. Growth in corporate fixed investment will gradually slacken in pace with other demand and output. Capacity utilisation may in time be brought down somewhat and stabilise. This will curb the rise in inflation, so that it stabilises close to target.

The economic outlook we have described, including the projected interest rate path, is based on the information Norges Bank currently has concerning the domestic and global economies and on Norges Bank's view of how the economy functions. Experience shows that the economy is exposed to disturbances that may result in other developments. In recent years, the unexpected fall in inflation, the sharp rise in oil prices and wide fluctuations in the krone exchange rate are events that were difficult to capture in advance in Norges Bank's projections. The origins of such disturbances may often lie outside Norway. The assessment of our near future and our current situation may change as time passes and as more accurate statistics become available. The functioning of the economy could also change.

Monetary policy is oriented towards stabilising inflation and output growth. If unexpected disturbances arise and new information concerning the functioning of the economy emerges, the Executive Board must assess whether a different interest rate path may be more appropriate in order to achieve our objectives. The interest rate outlook may therefore change over time. The fan charts illustrate the uncertainty that can be expected based on recent history.

The Executive Board discussed the main content of *Inflation Report* 3/05 before the report was published. On the basis of the analysis and the Executive Board's discussion, the Board assessed the consequences for the future interest rate path and approved the monetary policy strategy for the period to the next *Inflation Report* in March.

The interest rate path presented in the *Inflation Report* will, in the assessment of the Executive Board, provide a reasonable balance between the objective of bringing inflation up to target and the objective of stabilising developments in output and employment, conditional on the information Norges Bank had at the time the Report was published.

The interest rate may gradually - in small, not too frequent steps - be brought back towards a more normal level. The objective of bringing inflation back to target and anchoring inflation expectations nevertheless implies that monetary policy remains expansionary.

In the assessment of the Executive Board, the sight deposit rate should lie in the interval 2-3 per cent in the period to the publication of the next *Inflation Report* in March 2006, conditional on economic developments that are broadly in line with the projections.

In the press release following the Executive Board's meeting on 2 November, the following factors of uncertainty were highlighted:

- Stronger trade shifts and increased labour market competition may result in lower price and wage inflation and weaker pressures in the economy. In isolation, this would imply less frequent interest rate changes.
- We have little experience of such low interest rates over a long period. There is a risk that an interest rate that is kept low for a longer period may lead to expectations of a persistently low interest rate. This might result in a higher-than-projected rise in output and inflation and would in isolation suggest a faster interest rate increase.
- Developments in the global economy are uncertain. Our projections are based on favourable growth prospects in other countries and continued high oil prices.

> Different developments in global growth and in oil prices would result in a different path for the Norwegian economy.

Interest rate setting must also be assessed in the light of developments in property prices and credit. Wide fluctuations in these variables may constitute a source of instability in demand and output in the somewhat longer run. Safeguarding financial stability implies that the interest rate should be brought up towards a more normal level. If developments in the economy are in line with the baseline scenario, it is likely that financial developments in banks and enterprises will be favourable.

As mentioned above, however, developments ahead are uncertain and the Norwegian economy may be exposed to shocks. Uncertainty with regard to financial stability in the longer term is mainly related to the historically high household debt burden and to changes in asset prices. Long periods of a sharp rise in debt, asset prices and investments may give rise to instability and problems in the financial system at a later stage. We have observed this phenomenon both in Norway and in other countries.

The trend we have seen in household borrowing in recent years is not sustainable over time. The current interest rate level is very low compared with the level that over time must be considered more normal. Borrowers and lenders would probably be wise to bear this in mind.

Thank you for your attention.