Monetary policy and the outlook for the Norwegian economy

Speech by Governor Svein Gjedrem, Trondheim, 10 October 2005

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 21 September, Inflation Report 2/05 and on previous speeches.

Monetary policy in Norway is oriented towards low and stable inflation. 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 taking decisions about saving and investment today, although the result depends on how the economy develops in the future. In addition, we will seek to prevent unduly wide fluctuations in output and employment in the short and medium term. In the long term, output in an economy is determined by the supply of labour, capital and technology.

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 our assessment for the next three years, based on the analyses in the most recent *Inflation Report* published in June (*Inflation Report* 2/05) and updates at the most recent monetary policy meetings.

The economic situation

The Norwegian economy is in an upturn and is now expanding at a brisk pace. Inflation remains low, but has edged up since last year. The risk of a fall in the level of prices and markedly lower inflation expectations has diminished. At the same time, there appears to be little risk that inflation will rapidly move up to a level that is too high.

The interest rate reductions through 2003 and into 2004 have resulted in low real interest rates. For a period, the real interest rate has been considerably lower than normal. The low level of interest rates is supporting the high activity level in the Norwegian economy.

The economic upturn is broad-based. At the beginning of the recovery, activity was primarily fuelled by private consumption, traditional exports and petroleum investment. In addition, growth in mainland fixed investment has gradually gained considerable momentum.

Monetary policy easing and low inflation have resulted in strong growth in household real disposable income. Private consumption and housing investment have risen sharply. House prices have continued to rise. Debt growth remains high.

The economic upturn has continued this year. High petroleum investment, the international upturn and higher commodity prices have boosted output and earnings in the manufacturing sector. Statistics Norway's business tendency survey indicates continued favourable prospects for Norwegian manufacturing. Activity is expected to increase in service industries and the construction sector in the near term.

Capacity utilisation in the Norwegian economy now appears to be close to a normal level. In manufacturing, capacity utilisation is close to its historical average. According to Norges Bank's regional network, about 40 per cent of companies will have some or considerable difficulty in increasing production.

Even though growth in the Norwegian economy has been high for a long period, substantial pressures have not yet emerged in the labour market. The rise in the number of employed in the first half of the year was fairly modest in relation to output growth. This may be due to lagged effects of the sharp fall in sickness absence through 2004. In many companies, the large increase in available person-hours was probably not fully utilised immediately. A considerable share of output growth may be the result of improved utilisation of company workforces. According to the quarterly national accounts, employment rose by 0.5 per cent from the first half of last year to the same period this year. Measured by the Labour Force Survey (LFS), the number of employed rose by 12 000 from May to June and by a further 2 000 from June to July.

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 this country 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 of Norway come in addition.

An increased supply of labour from new EU member states to Norwegian enterprises may lead to 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 in India who are working from India on the Ormen Lange project in the western part of Norway. An increase in the use of these short-term contracts will appear as an increase in Norway's service imports, which contributes to increasing the supply of goods and services without drawing on domestic resources.

Protectionist measures may dampen the impact on the Norwegian economy of an increased supply of labour from the new EU member states. The transitional rules from 1 May last year stipulate that foreign workers shall have Norwegian wages and working conditions. At the same time, resources and appropriations for the supervision and control of foreign workers' wages and working conditions have been increased. As a result, foreign suppliers of services are losing much of their competitive edge in relation to Norwegian enterprises.

The latest Directorate of Labour figures show that seasonally adjusted unemployment was 3.4 per cent in September. This is in line with the developments we envisaged in the June *Inflation Report* (2/05). Statistics Norway's Labour Force Survey (LFS), however, presents a somewhat less favourable picture of unemployment.

Registered unemployment is on the decline in all regions. It took some time before unemployment began to decline in Central Norway, but during the last half year it has fallen substantially.

The industry structure in Trøndelag is very similar to that of the country as a whole. Nord-Trøndelag is the country's third largest agricultural county and employment in the primary industries is high. Even though the industry structure in the Trøndelag counties is not significantly different from the rest of the country, this region is nonetheless struggling with relatively high unemployment, even in periods of solid economic growth. Statistics Norway recently published a study that showed that the mobility in the labour market was lower in this region than in the country as a whole.[1] Companies have, for example, not been inclined to recruit recent graduates. This is an important challenge for the regional labour market authorities.

Information from Norges Bank's regional network is important 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 the labour market and business and industry throughout the country.

According to the most recent reports, the economic situation in Central Norway is favourable. The companies that are participating report stable employment and solid growth in all industries. The activity level is high in both manufacturing and construction, but growth is expected to level off. The supply of skilled labour is a constraint on the growth potential. The investment rate is stable and moderate. Enterprises in the region envisage a slight rise in prices in the period ahead.

Inflation decelerated markedly from summer 2003 and continued to fall in the beginning of 2004. Consumer price inflation has subsequently picked up, albeit at a gentle pace. In August, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) was 1.3 per cent. Adjusted for the interest rate's direct effect on house rents, the year-on-year rise in the CPI-ATE may be estimated at 1.5 per cent in August. The CPI rose by 1.9 per cent in the same period.

Prices for domestically produced goods and services rose by 2.1 per cent in the twelve months to August this year. Higher capacity utilisation is providing the basis for higher margins in some industries. 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. Lower-than-projected wage growth may be related to the fact that there were few signs of improvement in labour market conditions prior to this year's wage settlement. Lower-than-projected consumer price inflation last year may also have contributed. Low wage growth will in turn contribute to curbing the rise in prices for domestically produced goods and services.

Prices for imported consumer goods have continued to fall. The decline in prices may reflect high productivity growth in the production of some goods and large investments to increase production capacity, particularly in China. This has led to strong competition and a low rise in prices for internationally traded goods. The shift in imports, for example clothing imports, towards low-cost countries seems to be substantial again this year.

Structural changes in world trade have been important for the Norwegian economy, not least for the rise in prices for imported goods and services. The shift in imports towards low-cost countries has come gradually. We have expected that the import pattern would gradually become more stable, but if the shift continues, the price-dampening effects of increased imports from low-cost countries in Asia and Central and Eastern Europe may persist longer than assumed.

The change in China's exchange rate regime in July, with a 2 per cent revaluation of the Chinese currency, may over time have an impact on price developments for imported consumer goods.

The global economy

Economic growth among trading partners appears to be somewhat lower this year than in 2004. In the years ahead, growth is expected to be relatively stable.

The outlook for growth in different regions indicates that the imbalances in the global economy, with a large deficit in the US and large surpluses in a number of other countries, will persist.

There are particularly large imbalances both in the US balance of trade and current account. Persistent trade deficits have pushed up US foreign debt to a high level. This is partly due to the federal budget deficit. Moreover, US households have a high level of consumption and a low level of saving. This may be related to a more rapid rise in the US population than in other OECD countries. This suggests in isolation that saving in the US is somewhat lower and investment somewhat higher, but the impact is now considerably greater than implied by demographic factors alone.

The imbalances may persist, and may increase. International capital markets are deep and liquid with an ample supply of credit for US borrowers. So far, there is no indication that the US has problems in financing its deficit. If creditors begin to fear a fall in prices and withdraw from the market, substantial corrections may nevertheless be triggered. This may lead to higher interest rates and perhaps also a fall in US equity markets that spills over to other countries' financial markets. In that case, the dollar will also depreciate.

The household debt burden in the US may be another source of instability if households abruptly reduce both housing demand and consumption.

Strong demand in the US has sustained growth in the world economy. We assume that growth will slow somewhat in the US in the period ahead. A more pronounced downturn cannot be ruled out, however. An abrupt and pronounced downturn might fairly rapidly lead to declining growth in the entire OECD area.

The US is not the only source of trade imbalances. They also reflect very low growth in continental Europe and largely export-based growth in Asian countries. Therefore, countries other than the US must also contribute in order to prevent a decline in world economic growth. With limited domestic growth capacity and high unemployment, many industrial countries are poorly equipped to cope with a weaker dollar and lower demand from the US. The challenges are perhaps particularly demanding in some large European countries, whereas it appears that the Japanese economy is becoming more self-driven.

There is also a risk that large imbalances in world trade and low employment in Europe will trigger protectionism, which could reduce growth capacity even further. A pronounced slowdown in growth in the entire OECD area is also likely to lead to markedly slower growth in China and emerging economies in Asia because exports are an important driving force behind growth in the region. This could lead to an appreciable fall in prices for oil and other commodities and weak developments in the shipping industry. Just as Norway has benefited strongly from the sharp international upswing in recent years, the Norwegian economy could be affected by such a downturn.

The recent change in China's exchange rate regime and the revaluation of the Chinese currency by 2 per cent will probably not cause substantial changes in the imbalances in world trade. At the same time, daily fluctuations of 0.3 percentage point between the yuan and the dollar are now possible. This allows for considerable variation and it cannot be ruled out that more pronounced changes in the same direction will gradually occur. So far, the Chinese authorities have maintained a stable course.

It will probably be appropriate for both China and other Asian countries to shift more of their production towards domestic markets, which will reduce the large current account surpluses as well as curb the build-up of the official foreign exchange reserves. As part of this adjustment, the relative cost level will gradually increase.

Very high growth in demand for oil is one of the factors behind record high oil prices. In the first half of this year, the price of Brent Blend fluctuated for the most part between USD 45 and USD 55 per barrel. Oil prices have risen further this past summer and gradually rose to more than USD 60 per barrel. In the last few days, prices have been falling.

Oil futures have also increased.

Little excess production capacity in OPEC countries, combined with the prospect of lower production in non-OPEC countries, has probably influenced oil prices. At the same time, there are prospects of continued strong growth in demand in important oil-importing countries, such as China and a number of other emerging economies.

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 very pronounced, but there are now growing concerns that high oil prices may result in higher inflation and inflation expectations.

High oil prices have a different impact in Norway than in oil-importing countries. A rise in oil prices improves our terms of trade. Other countries perceive this as an externally imposed tax.

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.

The scale and spillover effects of petroleum investment are highly uncertain. The last time petroleum investment showed a sharp increase, in 1997/1998, growth was substantially stronger than had been assumed. At the same time, the rest of the Norwegian economy was experiencing an upturn. The unexpected increase in petroleum investment contributed to substantially stronger-than-projected economic growth. If oil prices rise further or remain at the current high level for a long period, petroleum investment may again reinforce the cyclical upturn more than projected.

Monetary policy and the outlook for the Norwegian economy

The analyses in *Inflation Report* 2/05 are based on a baseline scenario where the key rate shadows forward interest rates up to 2007, and then rises somewhat more rapidly. The krone exchange rate is assumed to shadow the forward exchange rate, which remains broadly unchanged over the next three years.

Capacity utilisation in the Norwegian economy is expected to increase this year and next and exceed its normal level. There are prospects that inflation will gradually pick up and be close to 2½ per cent at the three-year horizon. Since the publication of the June *Inflation Report*, prices for domestically produced consumer goods have risen slightly less than expected. At the same time, oil prices have been somewhat higher than assumed. Energy prices are pushing up consumer price inflation.

New information since the publication of the June *Inflation Report* does not provide grounds for changing the assessment of developments in the real economy. Growth among trading partners seems on the whole to be approximately as expected in the June *Inflation Report*, but the risk of more sluggish developments has increased, according to the IMF and the OECD. High oil prices may result in somewhat higher inflation abroad than previously projected.

The objectives of bringing inflation back to the target of 2.5 per cent and anchoring inflation expectations imply a continued low interest rate.

On the other hand, there are expectations that high output growth will persist. The objective of stabilising developments in output may, in isolation, imply a higher interest rate. Inflation is gradually picking up. High capacity utilisation may generate a continued sharp rise in property prices and household borrowing. This could be a source of instability in demand and output in the somewhat longer run.

The Executive Board's assessment in the June *Inflation Report was that the interest rate may gradually - in small, not too frequent steps - be brought up towards a more normal level if economic developments are approximately as projected in the Report. Such an interest rate path was considered to provide a reasonable balance between the objective of stabilising inflation at target and the objective of stabilising growth in output and employment. It was the Executive Board's assessment that the sight deposit rate should lie in the interval 1¾ - 2¾ per cent in the period up to the publication of the next Inflation Report on 2 November.*

Following the monetary policy meeting on 21 September, the Executive Board stated that developments in output, demand and underlying inflation had been consistent with the projections in the June *Inflation Report*. The Executive Board also stated that its monetary policy strategy and assessments indicate that the interest rate should be gradually increased in the period ahead. One option was to increase the interest rate at this meeting, but the Executive Board found it appropriate to leave the interest rate unchanged.

Household credit growth

Monetary policy easing through 2003 and into 2004 has resulted in low real interest rates. Short-term real interest rates may now be considerably lower than the level that implies long-term balance in the economy - the neutral real interest rate. A low real interest rate, and expectations of a continued low real interest rate, will contribute to stimulating activity even after the effects of the interest rate fall unwind.

Although the projections are based on rising real interest rates, the real interest rate will be lower than the neutral rate during the entire period. The monetary policy stance is therefore expansionary. So far, the effects do not appear to be stronger than expected, but we have little experience of such low interest rates. How quickly prices and wages will react when growth in output and employment picks up is uncertain. There is also 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 may involve a risk that capacity utilisation will remain high and that inflation will eventually overshoot the target.

Household debt has increased at a faster pace than income over the past ten years. Norges Bank's calculations indicate that debt growth may largely be due to the sharp rise in house prices in recent years. Higher house prices have a fairly prolonged effect on household debt growth. Even though the rise in house prices is expected to slow, credit growth will therefore remain high for a fairly long period. Given the assumptions underlying our projections, it is likely that debt will continue to grow at a faster pace than disposable income through the entire projection period.

The household debt burden has increased over the past year and is now record high. The interest rate burden is, however, relatively low. A normalisation of interest rates will increase households' net interest expenses, but according to the projections the interest burden will not be higher than it was at the end of the 1990s. Households will be vulnerable if unexpected disturbances result in higher-than-expected interest rates.

Challenges ahead

Petroleum activities give us an economic base that is not available to many other countries. But it also presents us with many challenges.

First, our petroleum resources are part of our national wealth. When oil is extracted and sold, petroleum wealth is transformed into financial assets. This wealth belongs not only to our generation, but also to future generations. It is reasonable to distribute our petroleum wealth equitably among generations.

The size of the cash flow from petroleum activities also varies considerably. If petroleum revenues were to be used as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy. Cyclical fluctuations would be much more pronounced.

Third, the use of petroleum revenues will have an impact on competitiveness in Norwegian business and industry. The level of and fluctuations in the use of petroleum revenues will have a considerable impact on the exchange rate and thus on growth in the regions with extensive export activities.

The Government Petroleum Fund was established in 1990 with a view to safeguarding long-term considerations in the use of petroleum revenues. In March 2001, the fiscal rule and new guidelines for monetary policy were introduced. The fiscal rule implies that the central government budget deficit shall be equivalent over time to the expected real return on the Government Petroleum Fund. The new guidelines for economic policy received broad support in the Storting.

The rule specifying that only the real return on the Petroleum Fund is to be used means that the capital in the Fund shall not be depleted. The capital in the Petroleum Fund will increase as long as there is a positive cash flow (to the central government) from petroleum activities. When the conversion from petroleum wealth to financial assets has been completed, the objective will still be to restrict withdrawals so that the real value of the Fund's capital is maintained - in principle, indefinitely.

The Petroleum Fund functions as a buffer against movements in the krone exchange rate when oil prices vary. The cash flow from an increase in oil prices will accrue to the Fund and be invested abroad. In this way, the Fund contributes to limiting an appreciation of the krone and maintaining a stable exchange rate. At times, it seems that participants in the foreign exchange market underestimate the Petroleum Fund's buffer mechanism.

Since the summer of 2004, the krone, measured by the trade-weighted exchange rate index (TWI), has appreciated by about 5 per cent. The chart shows the exchange rate and the price of oil since 1999. There does not appear to be any clear relationship between the nominal exchange rate and oil prices over time. The krone has appreciated in periods with high oil prices, but the same has occurred when oil prices have been low.

The correlation between the oil price and the krone exchange rate has varied over time. Since inflation targeting was introduced in March 2001, the average correlation has in fact been zero. This result is worth noting and indicates that the export of capital via the

Petroleum Fund has protected the nominal exchange rate from price fluctuations in the oil market. Therefore, there is cause for some optimism concerning the possibility of shielding the mainland economy from the effects of swings in oil prices. In the long run, however, petroleum revenues and their use will affect the level of costs in Norway.

An increase in oil prices may generate expectations of higher use of petroleum revenues in the future, particularly if high oil prices are expected to persist. Such expectations may exert appreciation pressures on the krone. It may also generate expectations of higher returns in the Norwegian stock market than in foreign markets, which also can and has contributed to an appreciation of the krone. Our assessment is that developments in oil prices and an increased cash flow have been responsible for the appreciation of the krone since the spring of 2004.

We are approaching a peak in petroleum production in Norway and must expect a substantial reduction in the next decades. In addition, there is considerable uncertainty associated with future petroleum production. In recent years, there has been a tendency to overestimate projections for production a couple of years ahead. It is especially demanding to estimate production for the many large fields that have reached maximum capacity.

The fiscal rule provides a long-term anchor for fiscal policy. It provides a stable framework that contributes to curbing some of the fluctuations in the Norwegian economy.

Nonetheless, the use of petroleum revenues in the Norwegian economy has been increasing over the past few years. Petroleum investment has increased significantly. In addition, the government uses more of the petroleum revenues than before. Growth in public expenditure started to accelerate in 1997 after having been low in the mid-1990s. Spending growth has also been fairly strong in recent years, but perhaps somewhat slower than earlier.

The fiscal rule for the budget implies that the government can use 4 per cent of the Fund over time. This year, around 6 per cent is being used. The deviation partly reflects an unexpected shortfall in tax revenues in recent years. The government budget deficit is the difference between total revenues and total expenditure. They each account for about half of total GDP in Norway. Even small deviations from expenditure and revenue projections can have a major impact on the deficit. Exchange rate changes will also lead to fluctuations in the value of the Petroleum Fund. For these reasons alone, the use of petroleum revenues may in periods deviate from the 4 per cent rule. Spending was also increased in response to the economic downturn. We can, therefore, safely affirm that the fiscal rule has been normative for fiscal policy.

Together with the fiscal rule, the monetary policy guidelines provide the framework for economic policy in Norway. The various components of economic policy have varying effects. This is why they have different functions:

- Monetary policy steers inflation in the medium and long term and can also contribute to smoothing swings in output and employment.

- The central government budget - growth in public expenditure - influences the krone and the size of the internationally exposed business sector in the medium term. Government expenditure and revenues must be in balance in the long term.
- Wage formation, the structure of the economy and incentives determine how well and how efficiently we utilise our labour resources and other economic resources.

There is also an interaction:

- In its budget resolutions, the government authorities will attach importance to the effects of the budget on the Norwegian economy and will therefore take account of interest rate effects. In this way, they avoid a situation where growth in public expenditure and the interest rate push the economy in different directions.
- With a known monetary policy response pattern, the parties to the centralised income settlements can take interest rate effects into account when wage increases are negotiated.
- Moreover, the parties to public sector negotiations can take into account that the higher pay increases are, the fewer people that can be paid over government budgets. The interaction here became clear when public sector employment fell after the expensive wage settlement in 2002.

The value of the Petroleum Fund, measured as a percentage of GDP, will rise in the years ahead. On the other hand, Norway, like many other countries, is facing substantial fiscal challenges. The expected dependency ratio, i.e. the ratio of persons over the age of 67 to persons aged 20 to 66, will rise sharply in the years ahead. The National Insurance Scheme's spending on old age and disability pensions, based on current social security rules, is increasing. The return on the Petroleum Fund can only cover a small portion of higher pension expenditure. According to Ministry of Finance calculations, a funding requirement equivalent to 6 per cent of GDP will still not be covered in 2060 given an oil price of NOK 230 (at constant prices) or around USD 35 per barrel. This is a relatively high estimate in terms of average prices in the last ten years, but at the same time oil futures are now far higher than this.

Increased saving today may be a way to address this challenge, but this is not enough in itself. In the long term, the most important factor will be how we manage our national wealth.

Thank you for your attention.

Footnotes

[1] Stambøl, L.S. (2005): Arbeidsmarkedsmobilitet i like og ulike regionale arbeidsmarkeder (Labour market mobility in similar and different labour markets), Økonomiske Analyser 4/2005, Statistics Norway