Developments in the Norwegian economy and banks

Speech by Governor Svein Gjedrem at the annual meeting of the Norwegian Savings Banks Association, Røros, on 25 September 2003

The discussion of monetary policy is based on the assessments presented at Norges Bank's press conference following the monetary policy meeting on 17 September.

The text below may differ slightly from the actual presentation.

Cyclical developments and monetary policy

The operational target of monetary policy is annual consumer price inflation of 2½ per cent over time. Consumer price inflation adjusted for tax changes and excluding energy products (CPI-ATE) was low for the first eight months of 2003. In the period May-August, inflation was below target by more than 1 percentage point. This primarily reflects a decline in prices for imported consumer goods, which is pushing down overall inflation.

In the years 1998-2002, the Norwegian economy was characterised by substantial labour shortages and a considerably higher rise in labour costs than among its trading partners. Last year was the fifth consecutive year of very high annual growth. Wage growth was considerably higher than the level that over time is consistent with the inflation target and with normal productivity growth. In Norges Bank's view, there was a considerable risk of new wage-wage spirals. Additional rounds of such strong wage increases might lead to a substantial decline in output and employment.

Monetary policy was therefore tightened through an interest rate increase last summer while the krone remained strong. At the one-year horizon, the strong krone would push inflation below 2½ per cent, but the effects of strong wage growth would subsequently dominate. Last year, Norges Bank's Executive Board struck a balance between the consideration of stable inflation in the short term and the consideration of stability in output and employment.

Inflation was therefore expected to be low in 2003. In the October 2002 *Inflation Report*, inflation was projected to fall to 1¾ per cent in summer 2003. Nevertheless, the difference between the outcome and the projection was unusually wide, which was to a large extent an indication that the economy had been exposed to substantial, unforeseen disturbances. Unexpected weak developments in the global economy led to lower interest rates abroad. Persistently low and falling interest rates abroad contributed to a strong krone, and reduced the effects of our own interest rate reductions in December 2002 and in 2003 on the krone and on inflation.

Negative events such as the accounting scandals in large US companies, fears of terror and war in Iraq and the spread of SARS resulted in slow growth and low inflation in other countries. Developments in global equity markets and the risk of higher oil prices also contributed to subdued international growth and at the same time strengthened the krone. Changes in the economic outlook may be mirrored in expectations concerning the future interest rate. In the US, interest rate expectations have been revised downwards substantially since summer 2002. The same applies to Europe.

In the Norwegian economy, reduced demand for some goods as a result of higher electricity bills probably resulted in lower profit margins. Competition and rationalisation may also have contributed to the lower-than-expected impact of strong wage growth on prices.

The interest rate reductions this year will make a significant contribution to bringing inflation back to target. In the short term, the effects will primarily be channelled through the weaker krone. In the somewhat longer term, interest rate reductions will also lead to higher inflation through stronger demand in Norway.

Capacity utilisation in the economy can be measured by the output gap. When the output gap is positive, the level of activity in the economy is high compared with trend output over time[1]. Norwegian employees claim higher wage increases when the economy is booming, and reduce their wage demands when the economy is at a low ebb. With productivity growth at about 2 per cent, wage growth over time of about 4½ per cent is consistent with our inflation target of 2½ per cent. The wage gap can therefore be defined as positive when wage growth is above 4½ per cent, and negative when it is lower. Wage gap developments are fairly closely correlated with the output gap.

Capacity utilisation in Norway has declined from a high level and is now on a par with the level prevailing in the years 1995- 1997, before the rise in costs accelerated. The wage gap is also currently around zero and on a par with the level prevailing when wage and cost inflation was moderate.

The interest rate reductions from December 2002 must also be seen in connection with stalling growth in the Norwegian economy last winter. Nevertheless, the Norwegian economy has been through a mild downturn, cf. developments in the output gap. It now appears that growth in the Norwegian economy will gradually pick up again. Thus, conditions are now more conducive to stability in output and employment. The Norwegian economy is projected by Norges Bank to grow approximately in pace with growth in the output potential, with the output gap and wage gap close to zero.

Norges Bank expects that a marked rise in consumption will result in renewed growth in the second half of 2003 and into 2004. This may gradually contribute to an increase in employment. Investment in mainland enterprises will also gradually pick up from a low level.

Growth in the global economy is also expected to accelerate and stimulate growth in Norway. The recovery in the US has not, however, led to higher employment. Combined with high household debt and a substantial budget deficit, this has added to the uncertainty about the strength and duration of the recovery. Economies in Europe continue to stagnate, but growth is expected to pick up next year. The outlook for inflation and thus for the interest rate abroad reflects continued slack and high unemployment in many countries.

The central government budget for 2003, which entailed moderate growth in public expenditure, has laid the basis for a marked reduction in the interest rate and has thereby contributed to a depreciation of the krone.

It appears that wage growth in 2003 will be appreciably lower than in previous years. The prospect that wage growth will slow to a more sustainable level has been an important element behind the easing of monetary policy. An interest rate as low as 2½ per cent, however, naturally reflects a long period of low interest rates abroad with little prospect of an increase in the near future.

Financial stability and monetary policy

Norges Bank is also responsible for promoting stability in the financial sector. Financial stability is often defined as the absence of financial instability. Those who experienced the banking crisis of the 1990s have a clear perception of what this means. Financial stability is characterised by unduly wide fluctuations in prices for assets such as dwellings, commercial property and securities, or failure in the functioning of financial institutions or financial markets. Financial instability is characterised by disturbances in the supply of credit or the flow of capital. In most cases, this will have consequences for output, employment and inflation. Thus, stability in the financial sector contributes to price stability.

Without smoothly functioning financial institutions and financial markets, the effects of interest rate changes on inflation and employment will be unstable and uncertain. Low and stable inflation provides households and enterprises with a clear indication of changes in relative prices. This makes it easier for economic agents to make the right decisions and contributes to greater price stability in financial and property markets. Low and stable inflation therefore provides the best foundation for financial stability. The two objectives normally underpin each other.

However, experience has shown that a conflict may arise between achieving the inflation target in the short term and financial stability. In Japan, equity and property prices surged in the 1980s, while inflation was low. In the US, household and corporate debt rose fairly sharply and equity prices trebled between 1994 and 1999, and inflation was moderate.

There are several reasons why financial and property bubbles can develop in periods of low inflation. Confidence in monetary policy contributes to low inflation expectations. Explicit or implicit long-term price and wage contracts will become more common. It takes longer for higher demand to translate into higher inflation, while asset prices may be affected more quickly. Cyclical changes will have less impact on inflation.

Moreover, periods of higher productivity growth may lay the basis for high corporate earnings, heightened optimism and reduced risk awareness. At the same time, with strong productivity growth, inflation remains low. Developments in the telecommunications and IT sectors have been highlighted as examples of this. Banks that record low losses and solid results can increase lending without eroding their capital adequacy level. Debt-financed investments may lead to a faster rise in house and property prices.

As a third factor, increased international competition may for a time contribute to subduing inflation even in a period of strong expansion, cf. the fall in prices for goods imported from China and other Asian countries.

Even though high asset prices and strong credit growth build up in a period of low inflation, these imbalances may influence inflation in the somewhat longer run. In that event, a tightening of monetary policy may be consistent with the objective of maintaining low and stable inflation over time. This will also stabilise production. A sharp rise in asset prices and debt build- up may pose a risk to economic stability. To minimise this risk, there may be situations when it is appropriate to apply a somewhat longer horizon than the normal two-year horizon for achieving the inflation target. A precondition for this is that financial market participants are confident that inflation will be low and stable over time.

Is there a conflict between the objectives of financial stability and price stability today?

Debt growth in Norway has been high for several years, resulting in a high overall debt burden for households, enterprises and municipalities. The downturn has reduced debt growth. Growth in domestic credit has moderated, while growth in credit from foreign sources has come to a halt and has even been negative in 2003. Total credit to mainland Norway, however, continues to rise more sharply than mainland GDP. The credit to GDP ratio is high both in a historical perspective and in comparison with other countries.

Over the past few years, credit growth has been far higher for households than for enterprises, reflecting a two-track economy, with strong growth in household income and low corporate earnings.

Household debt and the housing market
The level of household credit growth has remained high recently in spite of rising unemployment and a downward revision of the prospects for economic growth. An important reason for this is the sharp rise in house prices in recent years.

House prices in Norway have risen by an average 9.1 per cent annually between 1995 and 2002. House prices have also risen considerably in other countries. A sharp and sustained rise in house prices may contribute to high credit growth even after prices have levelled off. Because only a share of the total housing stock is sold each year, there will for a long time be houses on the market that are sold for a higher price than when they last changed hands. This has contributed to sustaining the high level of growth in credit to households in Norway even after the rise in house prices levelled off through 2002 and into 2003.

In addition, owners of houses that have risen in value have had the opportunity to raise new loans with dwellings as collateral to finance consumption or investments. Freeing up housing equity in this way is, however, less common in Norway than in countries such as the US, the UK and Denmark. These countries have well established systems for refinancing fixed rate mortgages easily and cheaply when interest rates are reduced. This has been an important factor behind the relatively strong growth in consumption in these countries.

A sustained high rise in house prices can in itself lead to expectations of further increases, thus becoming self-reinforcing for a period. This may then increase the likelihood of a subsequent fall in house prices, leaving household debt build-up more exposed to risk.

The level of house prices may be assessed in relation to building costs and wage growth. In relation to developments in the building cost index, resale house prices in Norway are about 20 per cent higher than the high level in 1987 before house prices fell. In relation to wage growth, real prices are still somewhat below the level recorded at that time.

Another way of assessing the level of house prices is to compare the price of a house with its potential rental income. The value of a house as an investment will depend on the expected future return, measured by the flow of future rental income. This kind of measure is often used in the equity market and is referred to as the P/E ratio of a share. The P/E ratio of a dwelling will be the price of the dwelling in relation to the flow of potential rental income.

The P/E ratio for the Norwegian housing market has been rising for the past ten years. At the end of 2002, the P/E ratio, as calculated here[2], was 6.5 per cent higher than at its peak in 1988. There has probably been an increase in house purchases for investment purposes, particularly in the large towns. Deregulation of the housing market and rising mobility has over time increased liquidity in this market, thereby making it more attractive to investors. In addition, a lack of other profitable investment options may have contributed to greater focus on the housing market. An increase in house purchases for investment purposes, i.e. with a view to generating rental income, will increase the P/E ratio directly through two channels: higher demand in the housing market pushes house prices (P) up, while higher supply in the rental market pushes rental rates (E) down. In general, households will be willing to pay more for houses when it is cheaper to service their debt. It is therefore, in isolation, reasonable to assume that the P/E ratio will rise when interest rates fall. However, a fall in interest rates will at the same time normally reflect weaker growth in employment and income. This tends to have the opposite effect.

From January to May 2003, house prices (adjusted for seasonal deviations) exhibited a downward trend. There are, however, signs that this year's interest rate reductions have started to have the desired effect. The number of houses sold has remained at a high level even though it takes longer to sell a house compared with last year.

Rising house prices increase housing wealth. Debt in relation to housing wealth therefore only increased marginally in recent years.

Debt in relation to disposable income, or the debt burden, is relatively high for Norwegian households compared with other countries.

However, if we look at debt in relation to wealth, the picture is very similar for all the Nordic countries. In Denmark, household financial wealth is high, while housing wealth is relatively high among households in Norway.

The high growth in household debt can be related to developments in the housing market. The amount households borrow will also depend on their capacity to service their debt. With rising income, households will be able to raise larger loans. The household debt burden has increased sharply since 1999 and is approaching the peak level reached during the banking crisis in 1992.

The change in monetary policy from an exchange rate target to an inflation target has probably made it less likely that households will be exposed to a "dual shock" in the form of higher unemployment and higher interest rates, as was the case during the banking crisis. Cyclical variations have also been considerably less pronounced over the past ten years. This may imply that households will opt for a somewhat higher debt burden than was the case prior to the banking crisis.

Today's interest rate level is historically very low, and long- term investment should not be based on the assumption that this level will be maintained over time.

High inflation would quickly reduce the real value of debt. It will often seem profitable to borrow large amounts as long as the borrower can bear a high liquidity burden in the initial period. The younger generation cannot, however, depend on receiving the same help from inflation as their parents.

Low and falling corporate debt growth
The situation in the business sector is completely different from that of households. Growth in corporate debt has declined markedly in the past few years. The corporate debt burden has, however, continued to increase and is now as high as in 1990. This is mainly the result of low growth in corporate income. High labour costs (as a result of strong wage growth over several years) and stagnation abroad have taken their toll on Norway's business and industry. The temporarily strong krone also had an impact in 2002.

Weaker cyclical developments resulted in a substantial increase in the number of bankruptcies in 2002. This trend has continued in 2003.

The increase in the number of bankruptcies must be seen in conjunction with high investment growth in the past. A period of economic expansion and strong optimism often leads to an increase in investment. In many industries, investment increased markedly as a share of real capital after the upturn began in 1993. In a number of industries, the investment rate was higher during this upturn than during the upturn that led to the banking crisis in the early 1990s. When the economy began to decline, unsound investments and overcapacity became visible. The fall in interest rates will ease the situation for enterprises.

More than 30 per cent of banks' loans to the business sector relate to commercial property. Rental rates in shopping centres and for shops and restaurants increased in 2002, bolstered by growth in private consumption. On the other hand, rising unemployment, for example in the ICT and consultancy sectors, has had a negative influence on the rental market for office space.

Rental rates for office space have fallen or levelled off in the largest towns in Norway. Rates for standard office premises in the centre of Oslo have fallen by 29 per cent compared with the peak level in 2001.

Vacant office space in Oslo, Asker and Bærum increased from 5 per cent in February 2002 to 10 per cent in February 2003. The weak developments in the office property market are reflected in the figures for building starts. From 2002 to 2003, the projection for completed projects in 2004 has been revised downwards by 80 per cent.

Satisfactory results in banks, in spite of higher losses

The two-track economy, with high household income growth and problems in the corporate sector, is also reflected in developments in losses and non-performing loans in savings and commercial banks. The number of non-performing loans in the retail market has remained stable over the past three years. Non- performing loans in the corporate sector have, on the other hand, exhibited a clear increase. The share of total non-performing loans is still considerably lower than in the early 1990s.

A large share of the losses in the corporate sector is related to loans in the fish farming industry, even though banks' loans to this sector are small on average. The property management sector accounts for over 30 per cent of banks' corporate loans. So far this year, losses in property management and other exposed sectors have been moderate.

The interest rate reductions in 2003 have exerted further pressure on banks' interest margins. In today's environment of falling lending rates and deposit rates that cannot fall below zero, banks are naturally interested in finding areas where they can reduce costs. The very unusual rise in the prices of both equities and bonds in the second quarter of 2003 will not persist.

Payment services in Norway have changed substantially over the past decade. Payment cards and electronic giro payments now account for the largest volume of transactions made by bank customers. These services are also the most efficient, and benefit extensively from economies of scale.

Customers should make use of efficient electronic solutions as far as possible. Banks' pricing policies for these services have been consistent and sound. Customers react to price increases by seeking cheaper alternatives. Even though there has been an increase in the prices for a number of services that have traditionally been widely used, average transaction costs for the public have not increased.

In addition, it takes time for a change in prices to result in a change in customer behaviour. The average price paid by customers for transactions (the blue line in Chart 20) has generally been falling. However, price increases for paper-based giros resulted in a rise in the average price for giro transactions (red line) in both 1995 and 2001, followed by a fall due to a change in payment behaviour. The number of electronic giro payments, particularly payments made using the Internet, is rising sharply, although it has taken some time for customer habits to change.

In our view, it is important that banks continue their policy of focusing on cost-based pricing. Over time, this will contribute to more efficient payment services.

Banks' performance in the period ahead partly depends on households' and enterprises' debt servicing capacity.

Household interest expenses accounted for over 7 per cent of their cash income (disposable income plus interest expenses) at the end of 2002. The recent interest rate reductions have considerably eased the interest burden. Developments ahead will be determined by household debt growth, income growth and the lending rate after tax. Corporate interest expenses in the same period accounted for close to 60 per cent of their cash surplus. For enterprises, developments will also depend on whether banks adjust their risk premium on high-risk loans.

Fixed rate mortgages reduce the vulnerability of households in Norway. Historically, fixed rate mortgages have not been common among Norwegian households. However, figures from the largest banks show that the share of fixed rate loans has recently increased.

Strong household income growth and weak corporate profitability have resulted in a shift in banks' lending policy, with banks seeking larger market shares in the retail market. The share of loans to the retail market has increased from 50 per cent in 1998 to 58 per cent in 2003. It should be noted here that the strengthening of employees' financial position at the expense of enterprises will not be sustained. Weak corporate profitability will, as has already been evident, result in higher unemployment and lower wage growth. This will in turn contribute to changes in the income distribution between employees and enterprises. It is important that savings banks are active in the loan market for small and medium-sized enterprises in order to provide alternative options for customers and in the interests of competition.

Most banks have satisfactory financial strength and are fairly well equipped to cope with losses. We therefore consider the outlook for financial stability to be satisfactory, even though loan losses have increased.

The current monetary policy stance

With reduced pressures in the economy and an inflation outlook that is below target at the two-year horizon, Norges Bank has reduced the key rate a number of times in the last year.

Without a considerable easing of monetary policy, inflation might have been too low for an extensive period. This might in turn lead to expectations of continued very low inflation. In this situation, it may be more demanding to boost activity in the economy. It has therefore been appropriate to reduce the interest rate considerably.

The low pay increases in this year's wage settlement may indicate that the social partners are placing more weight on the effects of pay increases on future developments in interest rates, the krone exchange rate and employment. In the light of experience from 2002, it must be assumed that government agencies will be more cautious in future wage settlements. The labour market outlook underpins expectations of moderate wage growth.

If households expect that interest rates will remain low, the rise in house prices and in household borrowing may again accelerate. The risk of stronger growth in household demand must be weighed against the sluggish developments in the business sector. Even though the krone has depreciated considerably from its strong level at the beginning of the year, enterprises' competitiveness is still relatively weak after many years of high wage growth. In addition, vacancy rates for commercial premises are high and rents have fallen.

Norges Bank's Executive Board sets the interest rate with a view to achieving the inflation target of 2½ per cent. The inflation target also provides a framework for stabilising output and employment. When setting the interest rate, the Executive Board seeks to strike a balance. On the one hand is the consideration of stimulating growth in the Norwegian economy and bringing inflation up to target. On the other hand, we must consider the risk of new pressures in the Norwegian economy when looking further ahead. Since December 2002, we have found it appropriate to reduce the interest rate to a low level. At the last monetary policy meeting on 17 September, it was decided to reduce the interest rate to 2.5 per cent. According to Norges Bank's assessment, with an interest rate of 2.5 per cent, the probability that inflation two years ahead will be higher than 2½ per cent was the same as the probability that it will be lower.

Thank you for your attention.

Footnotes

[1]The output gap measures the difference between actual and trend output. See box in *Inflation Report* 1/03.

[2]See *Financial Stability* 1/03