The Outlook for the Norwegian Economy

Speech by Governor Svein Gjedrem at the Bergen Chamber of Commerce and Industry, 11 April 2007

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 15 March and in Monetary Policy Report 1/07.

Introduction

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. Low and stable inflation provides enterprises and households with an anchor for inflation expectations. Given that there is confidence in the nominal anchor, monetary policy shall also contribute to stable developments in the real economy. Norges Bank therefore operates a flexible inflation targeting regime. This means that weight is given to both variability in inflation and variability in output and employment in interest-rate setting.

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.

Low inflation and solid growth in the Norwegian economy

Inflation in Norway decelerated markedly from the late-1980s to the mid-1990s and has since been low and stable, and fairly close to, but somewhat lower than the target of 2.5 per cent, with considerably lower variability than earlier.

Consumer prices show monthly variations. After a period of very low inflation in 2004, inflation was on the rise through 2005. Thereafter, domestic inflation showed an unexpected drop in 2006 and is still low. So far in 2007, it has edged up, but is still fairly low. Lower electricity prices have contributed to a fall in total CPI inflation in recent months. Underlying inflation, i.e. inflation adjusted for tax changes and excluding energy products, was fairly stable for a long period and has been estimated at between 1 and 1½ per cent. The latest inflation figure indicates that underlying inflation is now in the upper end of the interval.

The Norwegian economy is booming after a strong upturn since summer 2003. The upturn followed a period of slow growth from 1998 and a mild slowdown in 2002 and into 2003. Growth has been stronger than in the cyclical upturn in the mid-1990s. The growth period of recent years has been the longest unbroken growth period recorded in quarterly national accounts, which include figures back to 1978. Despite cyclical fluctuations, growth has been very high for the past 15 years. So far in the cyclical upturn, the mainland economy has grown by an average of just over 4 per cent annually.

Utilisation of production capacity, labour and real capital has increased markedly since summer 2003, and capacity utilisation is now very high in most industries. There are reports of limited capacity in most industries and regions and labour shortages in almost every occupational category. In some municipalities, the number of vacancies is higher than the number of job-seekers. There are also reports of shortages of other factor inputs. There are shortages of drivers, pre-school teachers, supervisors, engineers, carpenters, architects, auditors, accountants, IT personnel and health workers. It has probably not been since the 1970s that we find such widespread reports of purely physical production constraints, for example now in the form of shortages of rigs and other equipment in the petroleum industry or shortages of plank, concrete, insulation and scaffolding in the construction industry.

New national accounts figures show that activity in the Norwegian economy increased at a faster-than-projected pace in the period 2004 – 2006. The figures also indicate that productivity growth has been higher than expected. We interpret this to mean that the permanent level of production capacity has also increased. An alternative interpretation is that favourable cyclical developments are fuelling productivity growth. If that is the case, it may show a marked decline when economic growth slows.

Unemployment has fallen sharply in the past few quarters. The rate of decline and level of unemployment are reminiscent of two previous cyclical peaks, the one in the mid-1980s and the other that started in the late-1990s and continued into this decade. Both expansions culminated in a sharp rise in wage and cost inflation.

Employment growth was for a long period lower than in the cyclical upturns in the 1980s and 1990s. In the early phases of the upturn, output growth primarily reflected a strong increase in the number of person-hours worked partly owing to the marked increase in average working hours when sickness absence fell in 2004. A high level of inward labour migration after EU enlargement in 2004 also contributed to increasing economic capacity.

Historically, there has been a close relationship between the change in prices for domestically produced goods and services and the level of capacity utilisation, here measured by the output gap. This relationship broke down in 2006. Surprisingly low inflation through 2006, despite appreciably stronger output and employment growth, may indicate that developments have been influenced by conditions on the production and supply side of the economy.

The present economic expansion differs from previous upturns in that inflation has remained low so far despite strong growth and increasing capacity utilisation. There are probably several reasons for this.

First, low import prices and high prices for our commodity exports have improved Norway’s terms of trade considerably. Prices for oil and gas, shipping, fish, industrial commodities and engineering products have increased considerably. Moreover, Norwegian importers have gained access to new markets in central Europe and Asia which offer considerably cheaper consumer goods. The terms of trade have improved by about 40 per cent since 2002. A similar situation has not been seen since World War I when earnings in the shipping industry and other export industries were exceptionally high for a period.

Second, an ample supply of labour has boosted output growth. A strong increase in the population has expanded the growth capacity of the Norwegian economy without a comparable increase in wages. In particular, the supply of foreign labour has increased sharply after EU enlargement in 2004. Over the past two years, these labour inflows have accounted for over 30 per cent of growth in the labour force in Norway. At the same time, this has enabled Norwegian companies to be bolder in accepting new assignments and investing knowing that they can procure labour throughout Europe. In addition to increased labour inflows from Poland, Lithuania and other central European countries, we have long benefited from inflows of labour from Sweden. Many workers are on temporary assignment and their consumption is primarily concentrated in their home country. The Norwegian economy has seen a net capacity increase.

Third, the Norwegian business sector has been quick to integrate new technology. This applies both to companies competing on international markets and those supplying goods and services to the domestic market. In comparison with other countries, it is particularly productivity gains in banks and other service sectors that stand out. Examples are automated processes and swifter payments in the financial industry and improved inventory and management systems in commerce and transport. This results in lower production costs.

Solid productivity growth and high prices for export goods, and goods and services supplied to the petroleum sector have contributed to a fall in the wage share of Norwegian enterprises in recent years, despite a low rise in prices for consumer goods and services in Norway. Wage shares have also fallen in many other countries. The global supply of labour has increased as result of the integration of China, India and central European countries into world trade. This may have had a permanent effect on wage shares. Another possibility is that increased competition for labour will again push up wage shares.

The outlook for the Norwegian economy

Monetary policy influences the economy with a lag. Norges Bank therefore has to be forward-looking in interest rate setting. Developments in prices and capacity utilisation in Norway are influenced by both domestic conditions and economic developments in other countries.

Growth in the global economy is the strongest recorded in several decades. Continued high growth in China and India is contributing to holding up growth. Reforms in European product and service markets are also expected to lead to higher domestic demand. Growth in the US is expected to slow somewhat. A decline in housing construction and difficulties facing the US automotive industry are two of the main factors dragging down growth.

The turnover time in the US housing market has increased markedly and housing starts have shown a considerable decline. House price inflation has levelled off. There is a growing tendency towards mortgage payment problems for households with low debt-servicing capacity and creditworthiness. But so far the decline in the housing market has not had major spillover effects on either the wider US economy or the global economy.

Developments in international financial markets were marked by unrest during the winter months. Equity prices fell markedly, but are now close to the levels prevailing in February.

Short-term interest rates in the US are now expected to remain unchanged in the period to summer, but to fall somewhat during the latter part of autumn. In the euro area, there are prospects that interest rates will stabilise at around 4 per cent. Interest rates are expected to rise gradually in Sweden and to peak in the UK in the course of summer.

Buoyant growth in the global economy has contributed to very high prices for oil, gas and other commodities. Oil prices have averaged USD 59 per barrel so far this year, or close to USD 6 lower than the average in 2006. In the past week in particular, oil prices have increased markedly owing to the uncertainty surrounding the situation in the Middle East. Global demand for oil continues to grow, while production growth forecasts in non-OPEC countries have been revised downwards recently. Oil futures prices one to two years ahead are just below USD 70 per barrel.

Commodity prices rose sharply in the first six months of 2006 and have since remained at a high level. The experience of previous periods of wide variations in commodity prices indicate that rising prices gradually lead to increased supply and reduced demand. This in turn leads to a fall in prices. Lower futures prices than spot prices for several industrial metals indicate expectations of a price fall.

High oil prices over a longer period have boosted petroleum investment. Increased investment activity on the Norwegian continental shelf has accounted for a large share of growth in domestic activity in recent years. There is substantial uncertainty associated with future petroleum investment. The emergence of new, smaller companies will probably contribute to a steady level of investment in a number of small and medium-sized projects in the period ahead. Petroleum investment is expected to remain at a high level in the years ahead, but growth is expected to be more moderate.

According to the fiscal rule, the spending of petroleum revenues over time shall be in line with developments in the expected real return on the capital in the Government Pension Fund – Global, estimated at 4 per cent. In the National Budget for 2007, it is estimated that the real return on the Government Pension Fund – Global, measured in NOK, will increase sharply in the years ahead. Oil futures prices are higher than assumed in the National Budget. On the other hand, new forecasts from the Norwegian Petroleum Directorate show that petroleum production in the next few years may be significantly lower than assumed in the National Budget.

In a situation with a high level of activity in the Norwegian economy, petroleum revenue spending in the period ahead will be consistent with the fiscal rule if it increases at a slower pace than the expected real return on the Fund. In the next few years, growth in the structural, non-oil budget deficit is assumed to be somewhat lower than implied by the 4 per cent rule. However, public sector demand is still expected to make a positive contribution to total demand and production.

The enterprises in the regional network report continued growth in demand and production. Growth picked up towards the end of 2006 and has remained stable into 2007. Suppliers to the petroleum industry report the strongest growth, but there is also strong growth in manufacturing and the service sector. The market outlook for the next six months is favourable, even though enterprises as a whole expect growth to slacken. A lack of spare capacity is an important factor behind expectations of slower growth.

Enterprises in both Hordaland and Rogaland report that the cyclical upturn is continuing. However, many industries still reported slightly slower growth than in the previous round. This is true of manufacturing supplying the domestic market and the petroleum sector, the export industry and suppliers of services to the household and business sector. Retail trade, on the other hand, stands out with very high growth rates. Growth in building and construction is on a par with that prevailing toward the end of 2006. The high level of investment and activity in the oil and gas industry, coupled with the general boom, continues to generate strong growth impulses to the region. Growth is broad-based and there are good prospects of continued growth in the next few months.

A good half of the enterprises report difficulties in accommodating demand growth. This is a little lower than in the previous round. Capacity remains tight in manufacturing supplying the petroleum industry, building and construction and business services. The investment level is expected to rise in all industries. Profitability varies somewhat between sectors. It is solid in the supplier and export industries, retail trade and services, and stable in building and construction and manufacturing supplying the domestic market.

Employment has risen in all industries in Hordaland and Rogaland over the past three months. Employment has increased over several years in the business sector. In recent months, employment growth in the public sector has also picked up. Unemployment in the region is now a little lower than 2 per cent, which is lower than the average for Norway as a whole. Unemployment began to fall earlier in this region than in the country as a whole. Demand for labour is expected to increase in manufacturing and services in the next three months. In other industries, employment is expected to be relatively stable. The tight labour market is reflected in continued high wage growth.

Capacity utilisation in the Norwegian economy is expected to remain high through 2007. Higher wage growth and declining productivity growth are pushing up unit costs. Continued strong competition may prevent this cost increase from feeding fully through to prices. However, it is assumed that competition will curb inflation to a lesser extent in the period ahead and that high capacity utilisation and higher wage growth will gradually push up the rise in prices for domestically produced goods and services.

As mentioned, there are probably several reasons why the rise in prices for domestically produced goods and services is picking up somewhat later during this cyclical expansion than the historical relationship between the rise in these prices and capacity utilisation would imply. Moderate wage growth has contributed to low inflation in recent years. The subdued rise in prices for imported, processed intermediate goods has curbed the rise in prices for goods and services. In recent years, competition has increased in many product markets. In many industries, high productivity growth has also had a dampening effect on inflation. Some of these factors may continue to influence inflation in the period ahead, albeit to a lesser extent than earlier. Inflation is projected to near the inflation target of 2.5 per cent as from 2008.

At Norges Bank's Executive Board meeting on 15 March, the key policy rate was raised by 0.25 percentage point to 4.00 per cent. Furthermore, the Executive Board decided that the key policy rate should lie in the interval 4 - 5 per cent in the period to the publication of the next *Monetary Policy Report* on 27 June 2007, conditional on economic developments that are broadly in line with projections. According to the Executive Board's assessment, the prospects and balance of risks suggest that it would be appropriate to raise the interest rate gradually to about 5 per cent in the course of this year and to a somewhat higher level in the period to summer 2008.

Developments in the krone exchange rate will also influence the pace of interest rate hikes because a considerably stronger krone may result in inflation that is too low. Under an inflation targeting regime, it is important to be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low. The interest rate differential against trading partners may widen somewhat further ahead in the projection period. Since such a development is already widely expected in financial markets, we have assumed that it will have limited effects on the krone exchange rate. However, there is considerable uncertainty surrounding the exchange rate projection.

The projections are shrouded in uncertainty. The projections for inflation, output, the interest rate and other variables are based on an assessment of the current economic situation and the functioning of the economy. We have illustrated the uncertainty surrounding the projections for the interest rate, inflation and capacity utilisation with fan charts. The wider the fans, the more uncertain the forecasts are. If economic developments are broadly in line with projections, economic agents can also expect interest rate developments to be approximately as projected. On the other hand, the interest rate path may shift in relation to the current path if economic prospects change or if the effects of interest rate changes on output, employment and prices are different from those projected.

Thank you for your attention.