

# The economic situation and monetary policy

Speech by Governor Svein Gjedrem in Sandnessjøen on 4 September 2006

*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 16 August and Inflation Report 2/06.*

## The economic situation

The cyclical upturn in the Norwegian economy continues. Corporate sector profitability is solid. Companies are borrowing and investing. Employment is rising at a fast pace, unemployment is falling and household demand is still on the increase. Capacity utilisation in the economy is rising and a growing number of enterprises are facing constraints. Statistics Norway's business tendency survey for the second quarter is still giving positive signals regarding developments in Norwegian manufacturing. A clear majority of industrial leaders assess the general outlook for the third quarter as more positive than for the second quarter. At the same time, consumer price inflation excluding energy products remains low and is lower than the inflation target.

Norges Bank seeks to set the interest rate with a view to achieving a reasonable balance between the objective of stabilising inflation at target and the objective of stabilising developments 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. Low inflation in recent years is both the result of monetary policy assessments and unforeseen disturbances to the economy.

Towards the end of 2002, Norges Bank shifted its monetary stance in an accommodative direction as new information indicated that developments in output and unemployment might be weaker than projected and inflation might be lower than target. The key rate was reduced markedly in 2003 and 2004.

The low interest rate level has contributed to a considerable increase in demand for goods and services. Increased petroleum investment and favourable prices in markets for our export products have also made a contribution. So far in this cyclical upturn the mainland economy has expanded by an average of close to 4 per cent.

Wage developments reflect and influence the business cycle. Strong employment growth in the 1990s resulted in a rise in labour costs, which in turn had a dampening impact on growth. Moderate wage growth in recent years has been accompanied by a strong cyclical upturn. It appears that wage growth will be somewhat higher in 2006 than in 2005, but not higher than expected.

Employment growth was lower over a long period compared with the cyclical upturns in the 1980s and 1990s. During the first phase of the upturn, output growth was largely attributable to a sharp increase in person-hours worked. This partly reflected a marked

increase in average working hours when sickness absence declined in 2004. Higher activity did not therefore result in substantial labour market tightening. Additional labour inflows following the enlargement of the EU and the EEA in 2004 also contributed to increasing potential output. A substantial share of inward labour migration is accounted for by foreign companies with contracts in Norway.

Labour inflows from the new EU member states still appear to be growing rapidly, with the construction industry absorbing a particularly large share. On the other hand, a rise in sickness absence and the number of persons on disability benefits are pushing down potential output this year. Over the past six months, labour shortages in the Norwegian economy have come into increasing evidence.

Unemployment has shown a marked decline and is now at a low level. Employment is still on the rise, while the labour force has remained virtually unchanged in recent months. Registered unemployment, seasonally adjusted, stood at 2.5 per cent of the labour force in August. The number of registered unemployed adjusted for seasonal factors was around 61000. Unemployment has declined for all occupational groups, and has been most pronounced in manufacturing, the construction industry and in the engineering and ICT sectors.

Norges Bank's regional network also supports this picture. Reports from the regional network indicate that capacity utilisation is high in the construction industry and in manufacturing, particularly among suppliers to the petroleum industry. There were reports of shortages of engineers and project managers. Many of our contact enterprises in corporate services also reported increasing skills shortages. On the other hand, idle capacity is reported in retail trade and in household services.

There are limitations to how much the supply of Norwegian labour can increase ahead. Labour participation rates are at a historically high level, particularly when taking into account demographic developments.

Developments in the labour market are similar to the profile observed ahead of the period of accelerating wage and cost inflation that started in 1998. Several factors can explain why wage growth has been moderate so far during this cyclical upturn. An increase in inward labour migration and the opportunities provided by an international labour market may have resulted in greater emphasis on the high wage level in Norway relative to our trading partners. Inward labour migration has also contributed to reducing bottlenecks in some industries.

Developments in region North are fairly similar to the situation in the other regions of the country. Region North reported prospects of solid growth in most industries. Manufacturing, retail trade and the local government and hospital sectors expected moderate growth in investment. The service sector expected zero growth in investment. There were reports of moderate employment growth in all sectors, with the exception of the local government and hospital sectors where growth was unchanged. The supply of labour was relatively ample in manufacturing and retail trade in this region. The construction industry, services and the local government and hospital sectors reported that there was a limited supply of engineers, project managers and nurses.

In Helgeland, manufacturing and primary industries play a more important role than in region North. The public sector also plays a greater role than in the country as a whole, partly because public institutions such as the Brønnøysund Register Centre, the National Library, the Norwegian National Collection Agency and the Norwegian Broadcasting Corporation's licence division are located there.

Nordland is the largest producer of farmed fish in Norway. Over 126 000 tons were produced in 2005 according to Statistics Norway. Salmon accounted for the bulk of production. Salmon prices are high at present. Prices have fallen somewhat since June, but are still high, generating solid earnings in the industry.

Employment is rising in the region and unemployment is at its lowest level observed for several years. The development of the Skarv Idun fields is expected to boost employment and activity ahead, either directly through new supply contracts for enterprises in the region or through onshore support facilities in connection with field development. Field development can also generate a positive spillover into services, construction and manufacturing.

In Norway, inflation has edged up since the cyclical upturn started. The year-on-year rise in the consumer price index (CPI) was 2.2 per cent in July.

Energy products such as electricity and oil account for a considerable portion of the rise in prices over the past year. The year-on-year rise in energy prices was 16 per cent in July. Since the beginning of 2001, energy prices have exhibited an average increase of over 7 per cent. In the period ahead, the rate of increase in energy prices is expected to moderate, although prices will probably remain at a high level, with fairly wide variations around that level.

Variations in energy prices may also lead to wide monthly variations in consumer price inflation. High electricity prices may lead to a pick-up in CPI inflation through 2006. Through next year, a more moderate rise in energy prices may lead to lower CPI inflation.

The rise in prices for non-energy products has been moderate in recent years and has been marked by developments in import prices. In Norway, price impulses from imported consumer goods have been negative virtually every year since the mid-1990s. This is partly due to increased trade and a shift in imports towards low-cost countries. Price impulses from imported consumer goods are expected to continue to exert downward pressure on inflation in the period ahead, but to a lesser extent than in previous years.

The rise in prices for domestically produced goods and services pushed up CPI inflation up to this year. From autumn 2004 to autumn 2005, the rise in prices for domestically produced goods and services picked up. Since the beginning of the year, domestic inflation has edged down, hovering around 1.3 per cent. Adjusted for the reduction in day-care rates in January this year, the year-on-year rise in domestic prices has been 1.6 per cent. The rise in prices has been lower than expected for both goods and services. There may be several factors behind the low inflation rate. Strong competition between various producers within the food industry and construction industry may have had a dampening impact on inflation. In addition, productivity growth in retail trade has been high in the past few years. Intensified

competition may also have contributed to curbing the rise in prices for banking and insurance services.

Several factors point to higher inflation in the period ahead. Capacity utilisation in the Norwegian economy is rising, which will push up the rise in prices for domestically produced goods and services. A tighter labour market will probably lead to higher wage growth in the coming years. The rise in oil prices is pushing up producer input costs. Increased electricity costs may also translate into higher prices for domestically produced goods and services.

## **Outlook for the years ahead**

Monetary policy will increasingly have to reflect the constraints facing some Norwegian industries.

Oil prices are of importance for the activity level in the Norwegian economy and central government revenues. In recent years, oil prices have risen sharply. Crude oil prices rose to about USD 75 per barrel over the summer, partly owing to the conflict in the Middle East and reduced production in Nigeria and the US. In recent weeks, oil prices have edged back again. Brent Blend futures prices nevertheless indicate that oil prices will remain high several years ahead.

Export prices for Norwegian natural gas largely follow developments in oil prices with a lag. Since autumn 2005, prices for Norwegian gas exports have risen substantially according to the quarterly reports of the oil companies Statoil and Hydro. In the next few years, natural gas will account for a steadily larger share of total petroleum production on the Norwegian continental shelf.

Petroleum investment has reached a high level after three years of strong growth. In 2005, investment was close to NOK 87 billion, and it is expected to edge up again this year. The large Ormen Lange and Snøhvit projects have contributed to high petroleum investment, and high oil prices have fuelled activity even at oil fields that have been in production for a long period. The development of the Skarv Idun fields will contribute to holding up petroleum investment from 2007.

Information from our regional network suggests that petroleum investment provides considerable impulses to activity in Norway's coastal regions. According to the network, suppliers to the petroleum sector are expecting strong growth to continue in the coming months.

The level of investment is assumed to remain high next year, before declining somewhat the following year when Ormen Lange and Snøhvit are scheduled for completion. No plans have so far been adopted for new projects of a similar size, but continued high oil prices are expected to contribute to high investment both in exploration and in fields in operation in the years ahead.

There are prospects of strong growth in the Government Pension Fund-Global. Given our assumption for oil price developments ahead (oil futures), spending in line with the expected real return on the Fund implies that the structural, non-oil deficit may increase by close to

NOK 15 billion at 2006 prices in both 2008 and 2009. With a period of strong expansion in the Norwegian economy, somewhat lower petroleum revenue spending will be in line with the fiscal rule. Our projections are based on the assumption that fiscal policy will generate some stimulus to total demand and output in 2008 and 2009, but somewhat less than the expected return on the Fund would imply.

Economic growth in Sweden, the UK and the euro area is high. Economic developments in China and India remain strong. GDP growth in the US and Japan has slowed. Consumer price inflation among a number of our trading partners is high as a result of rising energy prices, but the increase in prices for other goods and services remains moderate. Continued solid growth among our trading partners is in prospect. As global capacity utilisation increases to a more normal level, demand for Norwegian exports might remain buoyant. A growing number of export enterprises are facing capacity constraints, particularly in the production of metals and refined petroleum products. Export growth in the years ahead will probably occur in industries such as the engineering and shipbuilding industries. Production growth is now high in these sectors, and employment is rising after declining for several years.

High growth in the global economy has also pushed up prices for non-oil commodities. Rising commodity prices and buoyant activity in markets that are important for Norway have generated growth impulses to the Norwegian economy. Since May this year, commodity prices have varied widely, but on the whole edged up since end-June. International equity markets have stabilised since the turbulence in May, and have edged up since the previous monetary policy meeting. The benchmark index on the Oslo Stock Exchange is now about 15 per cent higher than at the beginning of the year.

Interest rates are still low among many of our trading partners, in spite of the increases in several countries as a result of rising energy prices and higher consumer price inflation. In the US, there are now expectations that the rate tightening cycle is nearing an end, and that the policy rate will be lowered in the course of next summer. A rise in key rates is expected over the next year in the euro area, Sweden, the UK, Australia, Japan and Switzerland. In the June *Inflation Report*, Norges Bank assumes that money market rates among our trading partners will gradually increase over the next three years. The path for domestic and external interest rates does not imply considerable changes in the krone exchange rate.

Growth in disposable income has been high in recent years. Lower interest expenses as a result of the decrease in interest rates and relatively high real wage growth have resulted in an increase in household purchasing power. The rise in house prices may also have fuelled growth in private consumption. With high growth in employment and falling unemployment, consumption growth is expected to be high again this year. Since the publication of the June *Inflation Report*, electricity prices have increased to a further extent than expected. Forward prices for next winter have also increased. Higher electricity prices may in isolation reduce household purchasing power somewhat. On the other hand, growth in household income is high and there are market expectations of a fall in electricity prices later next year.

A continued rise in house prices may contribute to holding up consumption growth. House prices increased further this summer, and the twelve-month rise moved up to 15.8 per cent in July. Residential construction is still high. In 2005, the number of housing starts was the highest since the beginning of the 1980s.

As the interest rate level gradually normalises, household interest expenses will increase. Combined with projected lower employment growth and higher inflation, this might reduce growth in household purchasing power in the years ahead. Higher wage growth would have the opposite effect. Overall, moderate growth in household purchasing power is expected to result in lower consumption growth ahead.

A gradual increase in the interest rate will probably curb activity in the housing market. Housing investment is expected to grow through this year, although less rapidly than last year. Housing investment growth will thereafter moderate further, and may be somewhat reduced towards the end of the projection period. House price inflation is expected to slow.

Household indebtedness has increased in tandem with high activity in the housing market. Growth in household debt (C2) has abated somewhat in recent months, but remains at a high level. Higher interest rates and lower house price inflation will gradually reduce household debt growth in the next few years.

Growth in credit to mainland enterprises has also shown a sharp increase over the past year, partly reflecting increased fixed investment. With prospects of continued high capacity utilisation in the Norwegian economy, solid profitability, ample liquidity and a high level of optimism among enterprises, strong growth in investment is expected again this year. As economic growth gradually slows, investment growth is also expected to moderate.

## **Monetary policy assessments and strategy**

Monetary policy is oriented towards a gradual increase in the interest rate - in small, not too frequent steps - towards a more normal level. According to the monetary policy strategy in *Inflation Report 2/06*, the sight deposit rate should be in the interval 2¾ - 3¾ per cent in the period to the publication of the next *Inflation Report* on 1 November, conditional on economic developments that are broadly in line with projections. In the first six months of 2006, the key rate was increased twice by increments of 0.25 percentage point. There are prospects that the interest rate will rise further at about the same pace.

In line with this strategy, Norges Bank's Executive Board decided to raise the sight deposit rate by 0.25 percentage point to 3.00 per cent at its meeting on 16 August. Capacity constraints and a shortage of skilled labour were cited as mounting challenges to a number of industries. At the same time, corporate earnings are very high. Local government tax revenues have increased substantially. Household and corporate borrowing remains high. Property prices are rising markedly, and the level of building activity is high. Growth among our trading partners is solid, and a number of countries have raised their policy rates. These factors point to a higher interest rate.

At the same time, inflationary pressures, with the exception of energy prices, in the Norwegian economy remain fairly moderate. The krone exchange rate has depreciated recently, but over a period of several quarters the krone has varied around fairly strong levels. Exchange rate movements are difficult to project. The path for domestic and external interest rate does not imply any considerable changes in the krone exchange rate.

Moreover, the Executive Board pointed out that the objective of bringing inflation back towards the target and anchoring inflation expectations implies a continued expansionary monetary policy. It is likely that continued high growth in output and employment will result in a gradual pick-up in inflation. The interest rate will therefore be set so that monetary policy gradually becomes less expansionary.

Projections are uncertain. The uncertainty surrounding the interest rate forecasts is illustrated in the fan chart and indicates that monetary policy reacts to disturbances to the economy. This contributes to increasing the uncertainty surrounding future interest rates, but at the same time contributes to stabilising economic developments.

Monetary policy cannot fine-tune economic developments, but it can prevent the largest effects from occurring when the economy is exposed to disturbances. In some situations, it may be appropriate to hedge against particularly unfavourable developments. In the baseline scenario, the interest rate is gradually raised to a more normal level. Norges Bank continuously assesses the effects of interest rate changes and other new information concerning economic developments.

Thank you for your attention.