Svein Gjedrem: The economic outlook

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, Oslo, 18 March 2004.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 11 March and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

The Charts in pdf-format can be found on the Norges Bank's website.

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Your Excellencies, ladies and gentlemen

First of all, I would like to thank you for taking the time to attend this event, which provides me with an opportunity to present Norges Bank's view of the economic outlook.

Growth in the Norwegian economy is rising. Unemployment has stabilised. An economic turnaround has occurred, with a soft landing after a long period of high cost inflation. Monetary policy has contributed to stabilising output and employment - but inflation is low.

The interest rate level is in line with the level among our trading partners. Short-term interest rates in other countries have been unusually low over the past 2½ years, and there is little prospect of a sharp increase in the near term even if the world economy is expanding.

Activity in the Norwegian economy is expected to pick up in the coming years. The past and ongoing rationalisation in the business sector may enable enterprises to increase production considerably in the short term without strong employment growth. This suggests that there is room for somewhat stronger growth in the economy without pressures on real resources emerging.

The low inflation environment we have witnessed in Norway lately reflects global phenomena and trends. Globalisation, new technology and increased trade among countries are key forces affecting the Norwegian economy, in addition to exchange rate developments.

A global financial market

Cross-border capital flows have increased considerably in recent decades. Bond markets have moved more in tandem, particularly since the mid-1990s. This also applies to equity markets. Investors are increasingly spreading their investments across countries. They are diversifying risk, and seeking high returns. In parallel, governments, banks and companies are issuing more debt externally.

Currency trading has increased markedly since the 1980s. This trend was reversed when the number of currencies was reduced due to the introduction of the euro. Large trading volumes enhance market liquidity. The growth in currency trading reflects an increase in portfolio investment, higher foreign direct investment and growth in world trade.

The forward exchange and options market have expanded in recent years. A deeper market reduces transaction costs, and it is easier to find counterparties. This has provided companies with greater scope for hedging against foreign exchange risk. The use of instruments that reduce the risk associated with a floating krone is also increasing in Norway.

A considerably larger portion of credit in other countries is now channelled via the bond market. Less risk is being accumulated in banking systems. The development of new markets and instruments, for example credit derivatives, has also led to a broader risk spread than earlier.

The improved diversification of risk is probably one of the reasons that world financial markets have coped with the stock market decline and the accounting scandals with limited damage to the wider economy. This is probably one reason why the downturn following the stock market decline in 2000 was considerably less pronounced than during earlier downturns.

The new instruments spread risk, but do not eliminate it. Financial markets have become highly complex. This alone entails an operational risk, which is a challenge to participants and the supervisory authorities.

Increased trade promotes growth and lays a basis for prosperity. A number of Asian countries have experienced strong, export-led growth - Japan from the 1950s and several countries in Southeast Asia from the 1960s.

In recent years, China has become an important player in international trade, and is now probably the world's fourth largest trade nation. The Asian economies and the rest of the world have become more integrated.

Technological advances and a sharp fall in prices in the IT and telecommunications sectors have exposed a number of services that were previously sheltered from competition from low-cost countries.

EU enlargement this spring, with ten new members, is also influencing the division of labour in Europe.

Implications for the Norwegian economy

Intensified competition from Japanese and Korean shipyards had serious implications for Norwegian shipbuilding in the 1970s and 1980s. However, Japan has also become an important market for Norwegian products. From the considerable deficits of earlier years, trade in traditional goods with Japan has moved into near balance.

Strong growth in Asia is probably one of the prominent factors contributing to high oil prices in spite of low growth in the OECD area in recent years. China accounted for close to 50 per cent of growth in world oil consumption in 2002 and 2003. Trade in Asia has stimulated Norwegian shipping.

The Chinese economy could continue to expand at a brisk pace for a longer period, which would open a large market that can also be entered by Norwegian enterprises. Norwegian exports to China have increased, but are still limited. Over several years, enterprises in Central European countries have been a source of competition for Norwegian jobs. Integration is also opening new markets and providing new sources of income for Norwegian enterprises. At the same time, tender requirements and the freedom of establishment have increased the competition facing Norwegian industries that were previously sheltered.

A steadily larger share of Norway's consumer goods imports come from China and Central European countries. Growth in imports from China was provided with an additional impetus after China became a member of the World Trade Organization in 2001. Imports from Eastern Europe have also continued to grow.

There are many economic agents in Norway that are benefiting from globalisation. Consumers are enjoying lower prices for goods and services. Input prices have fallen and companies can sell their products in new markets. But there are also costs. Norwegian businesses and jobs may lose in the competition.

The challenge lies in moving idle resources to new business activities. This requires adaptability and a sound cost policy.

The Norwegian economy is unique in being both a fully developed economy and a major oil exporter. Norway is the world's third largest oil exporter. In the future, we will become an increasingly important exporter of natural gas.

The petroleum sector accounts for 44 per cent of exports and 17 per cent of GDP.

The present value of remaining petroleum reserves has been estimated at close to NOK 2 000 billion (present rate of net cash flow). The bulk of Norway's petroleum wealth will be extracted over a period of 40 years, from 1990 to 2030.

We are now in a phase where petroleum wealth is being converted from natural resources under the seabed to financial assets abroad.

The Government Petroleum Fund was established in 1990 with a view to promoting an even distribution of wealth across generations. The intention behind the Petroleum Fund is that the cash flow from petroleum production should be channeled to the Fund and invested abroad. By doing so, changes in oil prices have little effect on the mainland economy.

This chart illustrates how petroleum activity is separated from the mainland economy.

Oil companies' revenues are in foreign currency. The government net cash flow from taxes and direct ownership in oil companies is transferred directly to the Petroleum Fund. The return on the Petroleum Fund investments also adds to the capital.

Of the total capital accumulated last year, NOK 59 billion was spent over the fiscal budget.

The Petroleum Fund invests only in foreign markets.

The Fund serves as a buffer against shocks. Changes in petroleum revenues are absorbed in the Fund - not in the domestic economy.

The Petroleum Fund is owned by the government. At the end of 2003, the market value of the Petroleum Fund's assets was NOK 845 billion as indicated by the dark blue bars.

The Ministry of Finance has defined a clear mandate for Norges Bank's management of the Petroleum Fund. Norges Bank shall seek to achieve an excess return in relation to a benchmark portfolio. The return on the Petroleum Fund was 0.59 percentage point higher than the return on the benchmark portfolio in 2003. This is the sixth consecutive year with an excess return.

The return on the Government Petroleum Fund was 12.6 per cent in 2003. This is the Fund's highest return ever. The solid result is due to a high rate of return on equity investments, at 22.8 per cent. The return on the fixed-income portfolio was 5.3 per cent.

Since 1997, the average annual real return after management costs has been 3.7 per cent, measured in a common currency.

The Ministry of Finance has set a benchmark index for the Petroleum Fund. It has two functions. First, it expresses in a precise manner the strategy chosen by the Ministry. Second, it is a basis for comparison for the active management of the Fund. The benchmark index is a global securities portfolio, specified down to percentage holdings of individual securities.

The equity allocation is probably the most important decision in the composition of the benchmark index. The Petroleum Fund bases its choice on the fact that equities yield a higher expected rate of return than fixed-income investments.

Equities account for 40 per cent of the Petroleum Fund's strategic benchmark portfolio, and fixed-income instruments account for 60 per cent. In 2003, the equity portion of the benchmark consisting of securities listed in Europe was 50 per cent and the remaining 50 per cent in the Americas, Asia and Oceania.

The Petroleum Fund's average ownership in listed companies has increased. At end-2003, the average ownership interest in European companies, where the share is highest, was close to 0.5 per cent.

Macroeconomic policy in Norway rests on two pillars;

- The Storting issued formal guidelines to limit over time the annual use of petroleum revenues to the expected real return on the Fund - estimated at 4 per cent annually. That means that the government will not spend the capital itself - but only the return. In that way, the capital is saved for future generations.
- Monetary policy is aimed at ensuring low and stable inflation.

Monetary policy

The operational target of monetary policy as defined by the Government is inflation of close to 2.5 per cent over time. It is just as important to avoid an inflation rate that is too low as it is to avoid an inflation rate that is too high.

The inflation target provides economic agents with an anchor for their decisions concerning saving, investment, budgets and wages. The inflation target also provides a framework for monetary policy's contribution to stabilising output and employment.

The economy grows thanks to increases in the supply of labour and capital and technological progress. Average growth over time is referred to as trend growth. Owing to shocks to the economy, actual growth fluctuates around trend growth. The chart shows actual mainland GDP growth and trend GDP growth.

Normally, Norges Bank sets the interest rate with a view to achieving inflation of 2½ per cent two years ahead. A two-year horizon is applied because it takes approximately two years for an interest rate change to have a full impact.

A flexible exchange rate

Norway is a small open economy with a floating exchange rate.

The Norwegian krone does not stand out as particularly volatile. On the contrary, in countries like Sweden, the UK, Switzerland, Australia, Canada and New Zealand, the exchange rate fluctuates just as much - or more - than the Norwegian krone.

There is a cost involved for businesses in hedging against fluctuations in the krone. A krone that is stable - but too strong - also entails costs in the form of low activity. Similarly, a krone that is stable - but weak - is a source of high inflation.

Petroleum revenues generally provide substantial, but uneven currency inflows into Norway. The currency flows might have resulted in a strong krone and wide variations in the exchange rate. This tendency is countered when the annual use of petroleum revenues over the central government budget is predictable and independent of annual revenue inflows, and the remainder is invested abroad. The capital outflow through the Petroleum Fund contributes to both curbing the appreciation of the krone and maintaining its stability.

Norges Bank has not defined an exchange rate target. Nevertheless, developments in the krone are of considerable importance to interest-rate setting because exchange rate developments have an impact on inflation and output.

Although the krone may fluctuate in the short term, it will generally stabilise over time. When inflation has been higher in Norway than among our trading partners for a longer period, the krone has generally depreciated. When inflation in Norway is expected to be broadly in line with that of other countries, the exchange rate will normally also return to its long-term average following periods when the krone has been particularly strong or particularly weak. This provides a basis for stable exchange rate expectations.

Economic developments and prospects

As I mentioned in the introduction, the current picture is a broad-based economic recovery with low inflation.

Expectations of a global recovery have boosted stock markets over the last year. The Norwegian stock market index, OBX, has increased more than US, German and Japanese stock market indexes.

Oil prices and other commodity prices are also high.

Normally, higher growth expectations are accompanied by higher interest rate expectations. This has not been the case lately. On the contrary, market expectations have fallen. The red line shows that in October last year, the market expected that the economic recovery would lead to higher interest rates. The green and yellow line shows the fall in expectations, and that the market now expects interest rates to remain low for a period ahead.

The reason behind the change in expectations is the absence of inflationary pressures. In Norway, inflation is low. In February, annual core inflation fell to minus 0.1 per cent.

It is particularly prices for imported consumer goods - the yellow line in the chart - that have fallen sharply. But prices for goods and services produced in Norway have also declined. Increased competition and productivity growth have probably contributed to low inflation.

Higher productivity growth is a global trend and in particular in the US the phenomenon has been the subject of lively debate. The current economic recovery has in fact been labelled the “jobless recovery”, an indication that companies can increase production without new recruitment.

A change in trade patterns and external economic conditions have resulted in an unexpectedly sharp fall in import prices, even when measured in terms of what Norwegian importers pay in foreign currency.

Consumer price inflation in Norway declined sharply through 2003 due to cheaper import as the exchange rate strengthened. In addition, prices for imported goods have fallen measured in foreign currency as shown in the next chart. Chart 18. Price indicator for imported consumer goods. Foreign currency. Index

Again, this is a sign of the global trends I have mentioned earlier.

The change in trade patterns has made a considerable contribution to the sharp decline in prices for clothing and audiovisual equipment. Rapid technological advances have also pushed down prices for audiovisual equipment.

In Norway, competition has probably increased in the retail industry and other service sectors in recent years. Initially, stronger competition affects companies' profit margins. But enterprises will respond by reducing their costs. This will occur in part in the individual enterprise, but subcontractors will also be required to reduce their prices and enhance efficiency. Therefore, increased competition usually triggers higher productivity growth in the economy. Low inflation may therefore be matched by growth in productivity.

The prospect of low inflation, (due to a cyclical downturn last winter, low pay increases last year, fiscal discipline and an unexpected decline in inflation), has resulted in a considerable easing of monetary policy. The key interest rate has been reduced by 5¼ percentage points and is now approximately the same as among our trading partners. The krone has depreciated over the past year, and is in line with the average for the 1990s.

Monetary policy is expansionary. This is reflected in low after-tax real interest rates as shown in the chart. The low interest rate level has reduced household net interest expenses. This has increased household purchasing power considerably.

Household demand will probably be the most important driving force in the Norwegian economy in the period ahead. Private consumption has a considerable impact on overall demand and activity and accounts for 60 per cent of mainland GDP.

Low inflation and reduced interest expenses will support strong growth in household real income. Even with a moderate wage settlement, real income growth may reach about 5%. In addition, improved labour market conditions will strengthen job security and lead to expectations of higher income growth.

Against the background of high real income growth, improved job security and expectations of continued low interest rates ahead, household consumption is expected to exhibit strong growth. Growth in private consumption is projected at 5¼% between 2003 and 2004. Given this path, consumption will grow at a pace that is broadly in line with real income, with little change in the saving ratio.

After falling last year, house prices edged up in autumn. At the end of 2003, house price inflation was high. There are prospects that house prices may show a fairly sharp rise between 2003 and 2004.

Buoyant activity in the housing market and high house prices are contributing to strong growth in credit to households. The household debt burden has shown a considerable increase and is expected to rise further in the period ahead. A high debt burden means that an increase in interest rates to a more normal level may have a relatively pronounced impact on household income and hence consumption growth.

The difference in growth in credit to households and non-financial enterprises is a good illustration of Norway's dual economy. Over the past few years, credit growth has been far higher for households than for enterprises. The level of household credit growth has remained high recently. An important reason is the sharp rise in house prices in recent years.

Low investment demand is reflected in credit to non-financial enterprises, which has declined to a very low level. Developments in prices for commercial property compared with house prices also indicate that the situation is better for households.

Developments in mainland enterprises have been characterised by low output growth, falling investment and declining profitability in many industries. In order to boost returns on invested capital, enterprises have taken steps to reduce costs, primarily by reducing their workforce or relocating parts of their production abroad.

By way of conclusion, I would like to present a summary of the economic outlook for the Norwegian economy.

Growth in the Norwegian economy is projected to pick up this year, primarily fuelled by higher private consumption.

There are signs of high productivity growth, which means that companies can produce more with the same workforce. The high cost level in Norway and strong competition will probably induce many industries to continue reducing costs and rationalising. Against this background, the output potential of the Norwegian economy is assumed to increase more than normal in 2004. As demand edges up, enterprises' profitability will improve. At the same time, they may meet capacity constraints. Investment is therefore expected to pick up gradually and become a more important driving force behind the upturn. Mainland GDP growth is projected to pick up markedly this year and remain relatively high in 2005 and 2006.

Thank you for your attention.