Svein Gjedrem: The economic outlook and monetary policy

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at SR-banken, Stavanger, 18 March 2005.

The speech is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 16 March, Inflation Report 1/05 *and on previous speeches. 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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The Norwegian economy is growing at a solid pace, and there are prospects that growth will remain high in the year ahead. The recession was mild after the preceding expansion culminated two and a half years ago. The higher rate of cost inflation in Norway relative to other countries was broken without production being impacted to the same extent as during the recessions in the early 1980s and around 1990. One of the main reasons for this is probably that low inflation in the 1990s and the current monetary policy have anchored expectations of low and stable inflation among economic agents.

The need to bring down inflation was the main reason why New Zealand, the first country to do so, introduced an inflation target for monetary policy at the end of the 1980s. Canada, the UK, Sweden and Australia followed suit later in the 1990s. Inflation targeting has gradually become the normal monetary policy system in developed economies. In Norway, the Government introduced an inflation target in 2001. The target is set at 2.5 per cent. In the euro area, monetary policy is oriented towards price stability, defined as inflation below but close to 2 per cent.

Inflation targeting has proved to be a sound system and particularly well suited for small, open economies. Normally, interest rate setting under an inflation targeting regime will also contribute to stabilising output and employment. In periods of recession, with prospects of low and falling inflation, the interest rate will be reduced to boost demand and prevent an inflation level that is too low. During an upturn when there are prospects of high inflation, the interest rate will be increased. Inflation targeting is softer around the edges than the exchange rate regimes Norway and many other countries operated earlier. The system has proved fairly robust to disturbances.

Nevertheless, the soft landing of the Norwegian economy after several years of high domestic cost inflation and a low level of activity abroad must not lead us to believe that output and employment cannot show pronounced fluctuations in the future. We cannot expect the interest rate to have the same impact from one period to the next. The economy is also exposed to unexpected disturbances. As a result, we cannot fine-tune economic developments using the interest rate, but avoid the largest effects when the economy is exposed to disturbances. Experience seems to indicate that inflation expectations remain stable even if inflation varies somewhat as long as the interest rate is used actively to curb effects. Given our highly open economy, we may have to accept somewhat wider variations in inflation than some other countries.

The last time I was here, almost exactly a year ago, Norges Bank's Executive Board had just decided to reduce the key rate by 0.25 percentage point to 1.75 per cent. Since then, the key rate has remained at this historically low level.

Real interest rates are also low. From December 2002 to March 2004, the key rate was reduced by a total of 5.25 percentage points. The interest rate decline can be ascribed to a number of factors.

In late autumn 2002, inflation started to fall. The inflation projections were also revised down. Gradually new information about the outlook for other countries and the Norwegian economy indicated that inflation might be very low. Short-term interest rates fell by close to 4 percentage points. It would seem that it is not only changes in the real interest rate that have an influence, but also the level of real interest rates. Between December 2002 and March 2004, the interest rate has moved from a high to a low level. The real interest rate is now lower than a neutral interest rate. A real interest rate that is lower than the neutral rate will stimulate activity even after the effects of the interest rate fall itself have been exhausted.

Calculations seem to indicate that the neutral real interest rate for Norway is between 2½ and 3½ per cent, and it has probably fallen somewhat in recent years.

It takes time for an interest rate reduction to have an impact on inflation. We are now seeing the effects of monetary policy decisions some of which were taken two years ago.

The interest rate has affected inflation via the krone exchange rate and via demand for goods and services. In particular, the rise in prices for domestically produced goods and services has picked up. In addition, the reduction in the interest rate has probably contributed to holding up expectations of future inflation even when inflation is low.

If there is confidence in monetary policy, economic agents will expect inflation to be close to target over time. This will provide a basis for company budgets. This will then contribute to stabilising inflation. Many companies change their prices only once or twice a year. When they change prices, they probably take into account the expected rise in other prices.

It has been important to prevent inflation expectations from falling and becoming entrenched at a low level. Surveys of inflation expectations indicate that expectations are well anchored around the inflation target in the long term.

The first signs of the effects of the interest rate cuts appeared in the foreign exchange market. The interest rate differential against other countries narrowed. It became more attractive to borrow and less profitable to invest in the Norwegian krone. The movement in the krone exchange rate was reversed and it depreciated through 2003 and into 2004. However, the impact on the krone exchange rate has been considerably dampened because external interest rates have remained low. High prices for oil and gas and other export goods also contributed to an appreciation of the krone last year.

The depreciation of the krone in 2003 contributed to restraining the fall in prices for imported goods. The effect occurred gradually. Companies and importers may have preferred to observe changes in the exchange rate over time before changing their selling prices.

After several expensive wage settlements and a short period when the krone exchange rate was high had weakened profitability in the Norwegian business sector, the depreciation of the krone contributed to curbing the decline in activity and employment. The recession was short-lived.

Together with private consumption and fixed investment in the petroleum sector, traditional exports were an important factor underlying growth in the early stages of the upturn that started in the first half of 2003. Prices for many of our most important export goods have risen as a result of strong growth in new markets. Growth in Norway's total exports excluding oil and gas is, however, lower than import growth among our trading partners.

Mainland fixed investment has gradually become an important driving force behind the upturn. Investment has picked up in most industries and growth was stronger than expected towards the end of 2004. Norges Bank's regional network has registered rising investment in all industries. Petroleum investment in particular appears to be growing at a faster pace than projected. This may continue to boost mainland output.

In the past few years, household demand has been underpinned by low interest rates, high real wage growth and higher asset prices. According to preliminary national accounts figures, private consumption increased by 4.3 per cent last year. House price inflation has slowed somewhat, but remains high. Housing starts in 2004 were at the highest level for several years. Home refurbishment is probably also rising sharply.

Overall, the supply of capital to households has increased sharply. Debt accumulation was slightly higher than 11 per cent in 2004 and is now considerably higher than growth in household disposable income. This largely reflects the sharp rise in house prices since the mid-1990s.

According to TNS Gallup's consumer confidence indicator for the first quarter of 2005, households are still highly optimistic with regard to their personal finances and the domestic economy. Our regional network confirms this view with reports of strong growth in companies that provide goods and services to households. On the whole, household consumption and housing investment are projected to show fairly strong growth over the next few quarters.

Despite the strong upturn in the mainland economy, the rise in the number of employed has been fairly modest. Productivity rose quite sharply in the first few quarters after economic growth picked up. Normally, strong productivity growth is gradually followed by an increase in employment. The current upturn has lasted about two years. The fairly low level of growth in employment, as measured by the number of employed, must be seen in the light of the sharp decline in sickness absence through 2004 after rising for several years. The decrease in sickness absence has increased companies' supply of labour and reduced the need for new employees. Measured in person-hours worked, employment growth was solid last year. Person-hours worked increased by 2.2 per cent from 2003 to 2004. A corollary to the increase in the number of person-hours worked is partly reduced sickness absence and partly three more working days in 2004 compared with 2003.

An increase in available person-hours and increased competition and rationalisation in many sectors led to higher-than-normal growth in potential output last year. The economy has therefore been able to grow a fairly rapidly for a period without the emergence of bottlenecks in the labour market.

In the business tendency survey, manufacturing industry reported higher output volumes and capacity utilisation. Average capacity utilisation in the manufacturing sector is now close to its historical average. Norges Bank's regional network reports that nearly half of the contacts would have some or substantial problems in increasing production in excess of planned levels. This may indicate approximate balance between supply and demand in the economy, and that capacity utilisation is about normal. A normal level of capacity utilisation is consistent with an output gap – the percentage deviation between actual and potential output - that is now close to zero.

Growth in demand and output is expected to remain high in the near term. Unemployment may fall somewhat more quickly than has been the case over the past year. The output gap is expected to be positive in 2005.

Higher demand for companies' goods provides scope for increasing prices. Experience shows that inflation is directly influenced by the level of capacity utilisation in the Norwegian economy. Some of the rise in prices for domestically produced goods and services can be attributed to higher margins in the business sector.

The effects of the interest rate decline on demand, output and employment have been pronounced. It has taken time for inflation to pick up. This partly reflects low external interest rates and high oil prices, which have moderated the impact on the krone exchange rate. Higher imports from low-cost countries, competition and improved efficiency in Norwegian production have also kept inflation at a low level.

Initially, it was the fall in prices for imported consumer goods that pushed down underlying inflation. After a period, the rise in prices for domestically produced goods and services also decelerated. This was due in particular to increased competition in some goods and service markets. At the same time, wage growth slowed as a result of lower capacity utilisation in the economy. A slower rise in house rents also contributed. Inflation measured by the CPI-ATE reached its lowest level in the first months of 2004. Inflation remained at less than ½ per cent until after the summer before picking up in autumn. Inflation moved up primarily as a result of a slower decline in prices for imported consumer goods, but the depreciation of the krone since the beginning of 2003 has also contributed. In addition, the rise in prices for domestically produced goods and services stabilised, and towards the end of 2004 there was a tendency towards a higher rise in prices for these goods and services.

At the beginning of 2005, inflation measured by the CPI-ATE was lower than expected. Prices for imported consumer goods fell more than expected. It is uncertain whether this price decline was due to abnormal seasonal patterns or a fall in underlying inflation. The fall in prices may be related to an unusually warm winter, which has made it more difficult to sell winter clothing and sports equipment at ordinary prices. On the other hand, there are indications that prices for imported consumer goods in foreign currency may have fallen somewhat more than previously assumed.

The wide variations in prices for some imported consumer goods, especially clothing and footwear, may entail wide monthly variations in consumer price figures. Excluding changes in prices for clothing and footwear, the year-on-year rise in the CPI-ATE was 1.3 per cent in February, up from 1.1 per cent in January.

Changes in indirect taxes and particularly in VAT rates make it difficult to interpret the most recent price figures. The low level of inflation at the beginning of the year may be due to a lag in price adjustment following the indirect tax changes.

Among the companies in our regional network, the share expecting a sharper rise in selling prices is larger than the share expecting a slower rise in prices. TNS Gallup's business sentiment survey gives a more neutral impression. Nevertheless, both surveys indicate expectations of a sharper rise in prices in the service sector.

The other Nordic countries have also experienced falling inflation.

Inflation in the Nordic countries has declined, and is now relatively low in Sweden, Denmark, Finland and Norway. According to the harmonised indices of consumer prices, inflation in February was around 1 per cent in Denmark, Sweden and Norway, while the rise in prices remained unchanged in Finland, as measured by 12-month changes. By comparison, price inflation in the euro area was close to 2 per cent.

A common feature of the low level of inflation in the Nordic countries seems to be the trend in prices for imported consumer goods, even though developments have not been entirely the same in all the Nordic countries.

The upturn is broadly based, and its effects are no less pronounced here in Rogaland. Demand is increasing in all sectors, particularly in oil-related industries and the construction sector.

The market outlook for export-oriented and oil-related industries in the next six months is very bright and optimism is greater now than in the previous round of interviews. Domestically oriented manufacturing has not experienced large fluctuations in demand and output to the same extent.

It appears that growth in investment will increase in the period ahead: the high level of investment in the petroleum sector will contribute to higher investment growth in the offshore supplier industry. There are signs of rising investment in the construction industry. "Repatriation" is also being considered in Rogaland: the Gjestal Spinneri spinning company is looking at the possibility of investing in a new facility in Oltedal, enabling the company to transfer production from the UK to Norway.

Employment is rising, with the most marked increase in the construction sector. Almost a third of the enterprises report that shortages in the supply of qualified labour may constrain output growth.

Through the past year, there have been increasing reports of higher selling prices. One in four manufacturing enterprises is expecting a higher rise in prices this year than in 2004. In retail trade, two in three enterprises are expecting an accelerating rise in prices. The picture is mixed for the corporate service sector.

Profitability is still improving considerably in all sectors. This reflects both an increase in volume and cost reductions.

In the adopted budget for 2005, the structural, non-oil deficit increases compared with 2004. It therefore appears that fiscal policy will provide some stimulus to growth this year. In the National Budget for 2005, the underlying rise in expenditure over the central government budget was projected at 5.2 per cent, which is somewhat lower than the previous year and somewhat lower than projected nominal growth in mainland GDP. As from 2006, it is assumed that nominal growth in general government expenditure will be approximately the same as nominal growth in general government revenues and that the real tax level will remain unchanged.

Growth in the euro area and Japan was weaker towards the end of 2004 than projected in the November *Inflation Report*. It appears that it will take time for structural changes that have been implemented, in Germany for example, to contribute to an increase in output. In the US, on the other hand, economic growth remains firm and capacity utilisation is rising. Even though developments in the US economy are favourable, higher interest rates, among other factors, will gradually result in an increase in household saving. At the same time, the plans call for a lower rise in government spending. Weaker growth in US demand may imply slower growth also in other countries. In addition to the euro area, economic growth is expected to slow in the UK and Sweden.

On balance, we assume that growth among our trading partners will slacken this year and stabilise in the years ahead.

Growth in Asia, except Japan, and in Central and Eastern Europe is expected to moderate but to remain strong.

Robust expansion in China and India has in particular pushed up prices for oil and other important commodities. Growth impulses to the Norwegian economy may therefore be somewhat stronger than the overall outlook for our most important trading partners would indicate. High demand for commodities produced by Norway is boosting activity and is strengthening profitability for Norwegian enterprises.

Partly due to very high growth in demand for oil, the average price of Brent Blend rose to almost USD 40 per barrel in 2004. Strong economic growth, particularly in the US and China, has resulted in high energy consumption. So far this year, the price of Brent Blend oil has largely hovered around USD 45 per barrel, although the price rose to more than USD 50 per barrel at the beginning of March.

Oil futures prices have also increased. Little idle 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 demand growth in important oil-importing countries, such as China and some other emerging economies.

On the other hand, US crude oil stocks are now far larger than they were at the same time last year and the previous year. Petrol stocks are also relatively high. This reduces the risk that low stocks and high petrol demand will push up the price of crude oil, as was the case last summer.

Planned, large-scale projects resulted in strong growth in petroleum investment in 2004. Due to 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 level is expected to remain high throughout the projection period. Activity in the petroleum sector will have spillover effects on the mainland economy, initially on the shipbuilding industry and the construction sector.

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

Inflation among our trading partners is expected to be low over the next few years. It is likely that high prices for oil and other commodities will continue to push up prices for goods where wages account for a small portion of total costs. On the other hand, growth among most of our main trading partners will probably be too low for idle resources to be utilised in the next few years. Particularly in the euro area, wage growth is likely to be low as a result of moderate economic growth and high unemployment.

Overall, it would appear that international price impulses via consumer goods to the Norwegian economy will remain negative this year and next. There is no indication that growth in imports from low-cost countries is declining. For example, China’s share of footwear imports to Norway increased by 4 percentage points to 20 per cent in 2004. The share of clothing imports increased by 2 percentage points to 32 per cent. The decline in prices for clothing and footwear will probably continue in the coming years. Prices for audiovisual equipment are still falling as a result of strong international competition and high productivity growth.

We assume that the effects of structural changes in these markets will gradually be exhausted towards the end of the projection period. External price impulses via consumer goods are expected to increase in pace with unit labour costs among our trading partners.

The projections in *Inflation Report* 1/05, published on 16 March, are based on a gradual increase in the interest rate. This is in line with financial and foreign exchange market expectations. The krone exchange rate is assumed to move in line with the forward exchange rate. This implies that the krone will remain fairly stable around the current level in the years ahead.

Growth in private consumption is expected to remain buoyant both this year and next, primarily reflecting low real interest rates, strong growth in real disposable income and a continued rise in house prices. In the period ahead, higher employment and wage growth will continue to fuel household demand. On the other hand, household debt has risen sharply. This implies that a normalisation of interest rates will increase household net interest expenses. After a period, growth in consumption may be fairly low. However, we assume that households will spread consumption over time so that the savings ratio will continue to fall in spite of an increase in interest rates.

Growth in housing investment is expected to ease through 2005. However, the projection for housing starts is also very high for 2005. Such a high level of housing starts over several years probably means that more dwellings will be constructed than implied by underlying demand. As a result, housing investment is expected to decline after a period. Higher interest rates and weaker developments in the Norwegian economy may also lead to a fall in residential construction after a period.

The upturn in mainland fixed investment is broadly based. Stronger profitability, higher capacity utilisation and solid export growth will contribute to continued investment growth in goods-producing industries. Demand for services is expected to continue to grow for a period ahead with an attendant increase in investment in service sectors. When growth in the economy gradually slows down, investment growth will probably slacken.

Mainland exports of good and services from mainland Norway will also benefit from solid global growth this year. Later in the period, a continued loss of market shares as a result of high cost levels will dampen export growth.

Unemployment is expected to decline this year and next. In subsequent years, growth in demand and output is expected to ease, and unemployment may edge up again when capacity utilisation approaches a more normal level.

With a somewhat tighter labour market in the years ahead and rising inflation, wage growth may pick up. Over the past year, low consumer price inflation has probably contributed to keeping nominal wage increases lower than implied by labour market tightness in isolation. Low inflation has resulted in high growth in household purchasing power, even with moderate pay increases.

With a path for the interest rate and the krone exchange rate in line with the baseline scenario in *Inflation Report* 1/05, inflation may increase gradually from less that 1 per cent today to close to 2 per cent in mid-2006. Under these assumptions, inflation may stabilise at around 2½ per cent at the three-year horizon. However, continued shifts in trade patterns, with higher imports from Asia and intensified competition in retail trade, may prolong the period of low inflation.

Developments in the krone exchange rate are uncertain. The real krone exchange rate measured by relative labour costs is strong. Historically, the real krone exchange rate has tended to return to an average measured over a longer period. Should this occur in today's situation, through a depreciation of the nominal krone exchange rate, inflation will pick up somewhat faster than projected. If the krone appreciates, on the other hand, there is a risk that inflation will not move up as quickly as projected.

Developments in line with the projections imply that the output gap will increase to about 1¼ per cent in 2006. As the interest rate gradually increases to a more normal level, growth in private demand will probably ease, and capacity utilisation may be brought down and stabilise. There is uncertainty associated with developments in demand and output in the near term, partly because the interest rate has been low for a long period. Higher growth may rapidly trigger stronger pressures in the economy.

Output growth in Norway is high, and capacity utilisation is rising. It may appear that growth has become more self-driven. The low interest rate will probably contribute to an increase in the output gap and inflation ahead. The operational objective of monetary policy is inflation of close to 2.5 per cent over time. In the conduct of monetary policy, emphasis is also placed on curbing fluctuations in output and employment.

The objective of stabilising developments in output and employment implies, in isolation, a higher interest rate. This will reduce the risk that capacity utilisation in the Norwegian economy will become too high. High capacity utilisation could give rise to bottlenecks in some sectors of the economy and lead to a higher rise in property prices and household borrowing. This could be a source of instability in demand and output in the somewhat longer run.

The objective of bringing inflation back to target and anchoring inflation expectations nevertheless implies a continued expansionary monetary policy. International interest rates are rising, albeit slowly and from a low level. There are prospects of continued low inflation for a period ahead. Even if capacity utilisation in the Norwegian economy rises, there appears to be little risk that inflation will rapidly move up to a level that is too high. Inflation was unexpectedly low in the first months of this year, but in the light of our highly open economy we must perhaps expect somewhat wider variations in inflation than some other countries.

The projections and assessments presented in *Inflation Report* 1/05 may as a whole imply that the key rate can after a period, and then gradually, be brought up to a more normal level.

At its monetary policy meeting on 16 March, Norges Bank's Executive Board decided to leave the key rate, the sight deposit rate, unchanged at 1.75 per cent. The Executive Board weighed the objective of bringing inflation back to target and stable inflation expectations against the risk that output growth may eventually be too high.