Jarle Bergo: The Norwegian economy - possibilities and challenges

Address by Mr Jarle Bergo, Deputy Governor of Norges Bank (Central Bank of Norway), at a seminar hosted by Agder Research Foundation, Arendal, 12 May 2005.

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 20 April, Inflation Report 1/05 and on previous speeches.

The Charts in pdf-format *can also be found on the website of the Norges Bank.*

* * *

The Norwegian economy is growing at a solid pace and there are prospects that growth will remain high. The recession was mild after the previous expansion culminated in 2002. The period of relatively high cost inflation in Norway came to an end 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 current monetary policy have anchored expectations of low and stable inflation among economic agents.

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 recovery that started in the first half of 2003. Prices for many of our main export goods have risen as a result of strong growth in new markets. However, growth in Norway's total exports excluding oil and gas is lower than import growth among our trading partners.

Mainland fixed investment has gradually become an important driving force in 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 rapid pace. This may continue to boost mainland output.

Even with a strong upturn in the mainland economy, the increase in the number employed has been relatively modest. Productivity rose fairly sharply in the first few quarters after economic growth picked up. Normally, when productivity growth is strong, enterprises again begin to hire new staff. 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 the supply of labour to companies 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% 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.

Inflation has been low in recent years. Initially, the fall in prices for imported consumer goods pushed down underlying inflation. After a period, the rise in prices for domestically produced goods and services also slowed. Inflation measured by the CPI-ATE reached its lowest level in the first months of 2004. Inflation remained at less than ½% until after the summer before picking up in the autumn. Inflation moved up primarily as a result of a slower decline in prices for imported consumer goods. The depreciation of the krone since the beginning of 2003 has contributed to these developments. 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.

Prices for imported consumer goods fell more than expected at the beginning of 2005, while the tendency towards a more rapid rise in prices for domestically produced goods and services has persisted. So far in 2005, inflation measured by the CPI-ATE has been around ¾ per cent.

The other Nordic countries have also experienced falling inflation. Inflation has declined, and is now relatively low in Sweden, Denmark, Finland and Norway. The year-on-year rate of underlying inflation in these countries was around 1 per cent in March.

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

Reliable information about the economic situation is important when setting the interest rate. Information from the regional network is a useful supplement when assessing the current economic situation.

Region South reports high growth in activity in all industries. The market outlook is positive and more broadly based than previously. Growth in the export industry and the construction sector is expected to remain solid, although somewhat weaker than earlier. On the other hand, there is now more optimism in the retail trade and service sectors.

Capacity utilisation varies across industries. There is little excess capacity in the construction sector. Skilled labour in particular is in short supply. There is some excess manufacturing capacity, while considerable excess capacity is reported in retail trade and services.

The export industry is expecting a slower rise in prices for export products next year, while in general a stable rise in prices is expected in other industries.

Profitability is increasing, particularly in manufacturing for the domestic market, the construction sector and service industries.

Developments in employment show a mixed picture. Manufacturing employment is rising at a solid pace, while the level of employment is stable in the other sectors.

Growth in the global economy will have an impact on developments in the Norwegian economy in the period ahead. Global growth is expected to moderate somewhat this year and stabilise in the years ahead. In the US, growth seems to have remained solid in the first quarter. Heightened uncertainty with regard to developments in the US economy and weaker results for some large companies have resulted in falling prices on world stock exchanges. Developments are weaker in the euro area – unemployment remains high and consumer confidence has fallen. In Japan, it appears that growth will be positive from the fourth quarter of 2004 to the first quarter of 2005.

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

The outlook for growth in different regions indicates that the imbalances in the global economy, with large deficits in the US and large surpluses in some other countries, will persist. Low growth in the euro area and Japan is weakening the prospect of a gradual correction. This increases the risk associated with these imbalances. Increased imbalances in addition to high oil prices and volatile oil markets are contributing to the uncertainty surrounding developments in the global economy.

There are particularly large imbalances in the US balance of trade and current account. This partly reflects the US federal budget deficit. Moreover, US households have a high level of consumption and a low level of saving. Strong demand in the US has sustained growth in the world economy. The deficit in the US is matched by surpluses in Europe and Asia.

A persistent deficit has pushed up US foreign debt to a high level.

The US population is growing faster than that of other OECD countries. This may suggest that saving in the US is somewhat lower and investment somewhat higher than in other countries, but the impact is now considerably greater than implied by demographic factors alone.

The imbalances may continue for a period. International capital markets are deep and liquid with an ample supply of credit for US borrowers. If creditors begin to fear a fall in asset prices and withdraw, this may still trigger substantial corrections. This may lead to higher interest rates and perhaps also a fall in US equity markets that spills over to other countries' financial markets. In that case the dollar will also depreciate. The household debt burden in the US may be another source of instability if households abruptly reduce both housing demand and consumption.

The US is not the only source of trade imbalances. They also reflect very low growth in continental Europe and the largely export-based growth in Asian countries. Countries other than the US must therefore also contribute in order to prevent growth in the global economy from faltering.

With limited domestic growth capacity and high unemployment, many industrial countries are poorly equipped to cope with a weaker dollar and lower US demand. The challenges are perhaps particularly demanding in Japan and some large European countries.

There is also a risk that large imbalances in world trade and low employment in Europe will trigger protectionism, which could reduce growth capacity even further.

Partly due to very high growth in demand for oil, the average price for 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 moved between USD 45 and 55 per barrel. In the past few weeks, it has hovered around USD 50 per barrel.

Oil futures have also increased.

Little excess 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.

The IMF has analysed supply and demand in the oil market for the period ahead in the latest issue of "World Economic Outlook":

With price expectations at around the current level and global GDP growth at approximately 3 per cent, demand for oil is expected to increase by around 2 per cent per year over the coming decades up to 2030.

The rise primarily reflects higher demand for fuel for motor vehicles, particularly in non-OECD countries. An increase in per capita income in China will in particular lead to a sharp increase in car use.

Output in non-OPEC countries will peak soon – in 5 years, according to IMF estimates. Higher demand will thus require higher output in OPEC countries. These countries have substantial oil resources, but are currently producing close to capacity. Production capacity must therefore be increased.

Higher demand can thereby be met by non-OPEC oil producers operating at full capacity while OPEC passively accommodates any remaining demand by increasing its production capacity. Alternatively, OPEC can take a more active position and push up prices even further by capping production.

Only a few years ago, a long-term price of around USD 20-25 (in real value) per barrel was the normal estimate. Analyses such as that presented by the IMF suggest that the long-term oil price level may be considerably higher than this.

Let us return to the Norwegian economy, and the possibilities and challenges facing Norway.

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. It is assumed that the exchange rate will shadow movements in the forward exchange rate. This implies that the krone will remain fairly stable around the current level in the years ahead.

Mainly as a result of 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 engineering 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 to a greater extent than projected.

The upturn in mainland fixed investment is broadly based. Improved 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 expand for a period ahead with an attendant increase in investment in service sectors. When growth in the economy gradually slows, investment growth will probably slacken.

Mainland exports of goods and services will continue to 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.

Growth in private consumption is expected to remain high this year and next. Low real interest rates, solid growth in real disposable income and a continued rise in house prices will contribute.

Unemployment is projected 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 and rising inflation in the years ahead, 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.

The results from this year's wage settlement indicate that wage growth this year may be lower than the projection in the March *Inflation Report*.

Inflation among our trading partners is expected to be low in 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 external 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. 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 then expected to increase in pace with unit labour costs among our trading partners.

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 than 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. Developments in line with these projections imply that the output gap will increase to about 1¼ per cent in 2006. As the interest rate is gradually increased to a more normal level, growth in private demand will probably ease, and capacity utilisation may be brought down and stabilise.

Developments since the March Inflation Report was presented do not provide grounds for changing this perception of the state of the real economy. The results of the wage settlement so far suggest that wage growth this year will be somewhat lower than projected by Norges Bank. Inflation, on the other hand, has been broadly in line with expectations, and there has been virtually no change in the krone exchange rate. The inflation outlook has not changed substantially since the March *Inflation Report* was published.

At its meeting on 20 April, the Executive Board stated the following:

"The Norwegian economy is growing at a solid pace, and capacity utilisation is rising. An interest rate that is kept at the current level for a long period might lead to a situation where capacity utilisation becomes too high further ahead. Bottlenecks may arise in some sectors of the economy, and the sharp rise in property prices and borrowing may persist for a longer period. This could be a source of instability in demand, output and inflation in the somewhat longer run. This implies, in isolation, a higher interest rate. At the same time, the current rate of inflation is low, and there are prospects of low inflation for a period ahead. The objective of bringing inflation back to the target of 2½ per cent and anchoring inflation expectations imply a continued expansionary monetary policy.

The monetary policy assessments presented by Norges Bank in March indicated that the interest rate will rise after a period and at a gradual pace. Economic developments since then have been broadly in line with expectations. International key rates are rising, albeit slowly and from a low level. Although a gradual rise in the interest rate seems to provide a good balance between the different objectives, the Executive Board concluded that it is too early to increase the interest rate at this monetary policy meeting."

Low interest rates over a long period have contributed to strong growth in household borrowing. Both housing investment and house prices have risen sharply. House price inflation has slowed somewhat, but remains high. In 2004, housing starts were the highest in several years. Home refurbishment is probably also rising sharply.

The high level of borrowing has resulted in a substantial increase in the household debt burden. Loan debt relative to disposable income is now as high as at the end of the 1980s.

Interest expenses relative to income are nonetheless considerably lower now, whether based on current interest rates or expected rates in the next few years. Households will however be vulnerable if unexpected disturbances result in higher than expected interest rates.

Oil gives us an economic base that is not available to many other countries. But it also presents us with considerable challenges:

First, we must remember that our petroleum resources are part of our national wealth. When oil is extracted and sold, natural assets are transformed into financial wealth. Norway's national wealth belongs not only to our generation, but also to future generations. This means that our petroleum wealth must be equitably distributed between generations. The authorities must therefore exercise fiscal discipline, taking into account long-term considerations.

Moreover, the size of the cash flow from petroleum activities varies considerably. If petroleum revenues were to be used as they accrue, this would lead to considerable fluctuations in demand in the Norwegian economy, amplifying cyclical fluctuations as a result.

Third, the use of petroleum revenues would have an impact on competitiveness in Norwegian business and industry. A high level and substantial fluctuations in the use of petroleum revenues would have a negative impact on the operating parameters for internationally exposed industries. It is important that we succeed in maintaining an industry structure that promotes learning, innovation and development.

The Government Petroleum Fund was established in 1990 with a view to safeguarding long-term considerations in the use of petroleum revenues. In March 2001, the fiscal rule and new guidelines for monetary policy were introduced. The fiscal rule implies that the central government budget deficit shall be equivalent over time to the expected real return on the Government Petroleum Fund. The new guidelines for economic policy received broad support in the Storting.

The rule specifying that only the real return on the Petroleum Fund is to be used means that the capital in the Fund is not depleted. The capital in the Petroleum Fund will increase as long as there is a positive cash flow (to the central government) from petroleum activities. When the conversion from petroleum revenues to financial wealth has been completed, the objective will still be to restrict withdrawals so that the real value of the Fund's capital is maintained - in principle, indefinitely.

The fiscal rule thereby provides a long-term anchor for fiscal policy. It provides a stable framework that contributes to curbing fluctuations in the Norwegian economy that are caused by converting petroleum revenues into investment at home and abroad.

The new guidelines have changed the interaction between the different components of economic policy. Monetary policy has been given a clearer role in stabilising economic developments. A clear monetary policy objective is a necessary complement to the fiscal rule for ensuring reasonable macroeconomic stability. The operational target of monetary policy as defined by the Government is inflation of close to 2.5 per cent over time. The inflation target provides an anchor for economic agents' choices concerning saving, investment, budgets and wages. Households, businesses, public entities, employees and employers can base decisions on the assumption that inflation in Norway will be 2.5 per cent over time.

High oil prices have a different impact in Norway than in oil-importing countries. When oil prices increase, the value of Norway's national wealth rises. The idea behind the Petroleum Fund is that the cash flow from an increase in oil prices should accrue to the Fund and be invested abroad and should not be included directly in the government budget. As a result, the increase in the cash flow will not affect the domestic economy. Likewise, a fall in oil prices will not have an immediate impact on the domestic economy, but result in a lower accumulation of foreign assets.

Even though the Petroleum Fund and the fiscal rule shield the Norwegian economy to a certain extent from fluctuations in the oil market, the Norwegian economy will still be affected by developments in oil prices. If changes in oil prices influence growth in the global economy, this will in turn impact Norwegian exports of traditional goods and services. Petroleum investment on the Norwegian continental shelf is another important channel. Fluctuating oil prices contribute to substantial variations in petroleum investment. This has spillover effects on the mainland economy.

The value of the Petroleum Fund, measured as a percentage of GDP, will rise in the years ahead. On the other hand, Norway, like many other countries, is facing substantial fiscal challenges. The expected dependency ratio, i.e. the ratio of persons over the age of 67 to persons aged 20 to 66, will rise sharply in the years ahead. The National Insurance Scheme's spending on old age and disability pensions, based on the current social security rules, is increasing.

The return on the Petroleum Fund can only cover a small portion of this increase. According to Ministry of Finance calculations, a funding requirement equivalent to 6 per cent of GDP will still be uncovered in 2060 given an oil price of NOK 230 (2005-kroner), or around USD 35 per barrel. Oil futures 6-7 years ahead are now higher than this. If oil prices remain as high for the foreseeable future, the funding requirement will be somewhat lower. To base decisions on this, however, would be a very risky strategy.

Even though Norway's petroleum wealth is substantial, it is our human resources that account for most of our national wealth. Even a small increase in the "return" on human capital might generate considerable gains. The return on this capital partly depends on our pension schemes and the application of social security rules. These should be designed in such a way that they provide incentives and opportunities to work. Labour market legislation must also promote production and employment.

The Storting (Norwegian parliament) is currently in the process of completing its deliberations on the Pension Commission's proposals for reforming the national insurance system. If we succeed in reducing the dependency ratio through a modernised national insurance system and other reforms, this will be an important contribution to addressing the fiscal challenges we are facing.