Jarle Bergo: The outlook for the Norwegian economy and the challenges ahead

Speech by Mr Jarle Bergo, Deputy Governor of Norges Bank (Central Bank of Norway), at Norges Bank, Bodø, 25 August 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 11 August, Inflation Report 2/05 and on previous speeches.

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

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The economic situation

The Norwegian economy is in an upturn and is now expanding at a brisk pace. Inflation remains low, but has edged up since last year. The risk of a fall in the level of prices and markedly lower inflation expectations has diminished. At the same time, there appears to be little risk that inflation will rapidly move up to a level that is too high.

The reduction in the interest rate through 2003 and into 2004 has resulted in low real interest rates. For a period, the real interest rate has been considerably lower than normal. The low level of interest rates is supporting the high activity level in the Norwegian economy.

The economic upturn is broad-based. At the beginning of the recovery, activity was primarily fuelled by private consumption, traditional exports and petroleum investment. In addition, growth in mainland fixed investment has gradually gained considerable momentum.

The easing of monetary policy and low inflation have resulted in strong growth in household real disposable income. Private consumption and housing investment have risen sharply. House prices have continued to rise. Debt growth remains high. We expect that growth in household demand will continue this year and next.

Mainland business fixed investment expanded sharply in the last quarters of 2004. Moderate wage growth, low interest rates and rising demand have improved corporate profitability. Reports from Norges Bank's regional network point to a continued increase in corporate profitability. There are prospects of continued high growth in investment ahead.

Higher prices for many Norwegian export goods and solid global growth have generated growth in traditional merchandise exports. High export prices have contributed to an increase in capacity and higher exports from the processing industry. Some moderation in global growth is expected to result in somewhat slower growth in Norwegian exports of traditional goods ahead.

Import growth has been strong in recent years and picked up last year. Brisk demand for imported goods and services reflects strong growth in the Norwegian economy and a low rise in prices for some imported goods. In addition, a larger share of demand growth, for example in the construction industry, has probably been satisfied by increased imports of services.

The economic upturn is expected to continue this year. High petroleum investment, the international upturn and higher commodity prices have boosted production and earnings in the manufacturing sector. Statistics Norway's business tendency survey points to continued favourable prospects for Norwegian manufacturing. Service industries and the construction sector expect that continued low interest rates and strong growth in household demand will contribute to further increasing activity in the near term.

As estimated here, capacity utilisation in the Norwegian economy is now close to a normal level. In manufacturing, capacity utilisation has been close to its historical average. According to Norges Bank's regional network, about 40 per cent of enterprises will have some or considerable difficulty if production must be increased.

The situation in the labour market does not indicate a build-up of substantial pressures in the Norwegian economy as a whole, even though growth has been high for a fairly long period. So far, the rise in the number of employed has been fairly moderate in relation to output growth. This may be due to lagged effects of the sharp fall in sickness absence through 2004. Many companies have probably not fully utilised the large increase in available person-hours. A considerable share of production growth so far this year may be the result of an improved utilisation of the existing workforce. In addition, productivity, measured in terms of value added per person-hour, increased at a fairly brisk pace in the last couple of years.

In addition to high productivity growth and a reduction in sickness absence, it appears that the use of foreign labour has increased recently. The level is relatively moderate, but appears nonetheless to have reduced bottleneck tendencies in some industries where demand has increased sharply.

Many foreign workers who come to Norway find employment in Norwegian enterprises. This represents an increase in the supply of labour in Norway. Employment will thus be able to increase to a further extent than would otherwise have been the case without the emergence of labour shortages. In isolation, an increased supply of labour from new EU countries may lead to a higher-than-normal increase in potential output for a period.

Many of the foreign workers work for a shorter period in Norway without being employed in a Norwegian enterprise. Examples are foreign contractors and self-employed in the construction industry who carry out various building projects in Norway. An increase in the use of these short-term contracts will appear as an increase in Norway's services imports, and contribute to increasing the supply of goods and services without drawing on domestic resources.

Inflation decelerated markedly from summer 2003 and continued to fall in the beginning of 2004. Subsequently, consumer price inflation has picked up, albeit at a gentle pace. In July, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products was 1.1 per cent.

Prices for imported consumer goods have continued to fall. The price fall may reflect high productivity growth in the production of some goods and large investments to increase production capacity, particularly in China. This has led to strong competition and a low rise in prices for internationally traded goods. The shift in imports, for example clothing imports, towards low-cost countries seems to be substantial again this year.

Prices for domestically produced goods and services rose by 2.1 per cent in the twelve months to July this year. Higher capacity utilisation is providing the basis for higher margins in some industries. Service prices, which showed little rise last year, have increased again this year. In many industries, including the airline industry, where price competition is strong, low profitability has led to an increase in prices. High oil prices have also resulted in price increases, for example in the transport industry.

On the basis of the pay increases agreed upon in this year's wage settlement, combined with the estimates for wage drift and wage carry-over, annual wage growth is projected at around 3½ per cent this year. Lower-than-projected wage growth may be related to the fact that there were few signs of improvement in labour market conditions prior to this year's wage settlement. Lower-than-projected consumer price inflation last year may also have contributed to restraining wage demands this year. Low wage growth will contribute to dampening the rise in prices for domestically produced goods and services.

Information from Norges Bank's regional network is important for Norges Bank's analysis of the Norwegian economy. Information about the state of the Norwegian economy is available earlier than information provided by official statistics, and it is informative to have closer contact with the labour market and business and industry.

The situation in Region North, as in the rest of the country, is favourable. In the May round of interviews, all sectors in the region reported continued growth. Expectations concerning the next six months indicate accelerating growth for domestically oriented industry and continued solid growth for the export industry. Higher growth is also expected in both household and corporate services.

The solid growth in retail trade is expected to continue in Region North, while growth in the building and construction sector appears to be slowing somewhat.

According to our regional network contacts in the region, employment has fallen somewhat in the manufacturing and public sectors. In the near term, employment in building and construction and the service sector is expected to increase, while employment in all other sectors is expected to remain unchanged.

The supply of qualified labour in the region is satisfactory, and growth in profitability is solid, but moderating.

The global economy

Global economic growth is expected to be somewhat lower this year than in 2004. In the US, growth was solid during the first half of 2005, and it appears that this trend will persist. In the longer term, growth is expected to moderate somewhat. In the euro area, growth is expected to remain fairly weak during the next couple of years. In the UK, growth has slowed markedly and is expected to be moderate in the period ahead. In Sweden, growth has edged up following a couple of weak quarters and is expected to remain at approximately the same level. In Japan, there was a marked decline in growth from the first to the second quarter, and growth is expected to be fairly moderate in the period ahead. Growth remains high in China.

Growth among trading partners is expected to slow this year. In the years ahead, we expect that growth will be relatively stable. Uncertainties that may contribute to weaker developments include high oil prices and the possibility of weaker housing markets in a number of countries. On the other hand, solid business sector profitability in many countries may result in stronger investment growth than assumed.

The outlook for growth in different regions indicates that the imbalances in the global economy, with a large deficit in the US and large surpluses in a number of 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 both in the US balance of trade and current account. This is partly due to the 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 offset by surpluses in Europe and Asia.

Persistent deficits have 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, but the impact is now considerably greater than implied by demographic factors alone.

The imbalances may persist 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 prices and withdraw from the market, substantial corrections may nevertheless be triggered. 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.

We assume that growth will moderate somewhat in the US in the period ahead. A more pronounced downturn in the US cannot be ruled out, however. An abrupt and pronounced downturn in the US will lead quite rapidly to falling growth rates in the entire OECD area.

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.

A pronounced slowdown in growth in the entire OECD area is also likely to lead to markedly slower growth in China and emerging economies in Asia because exports are an important driving force behind growth in the region. This could lead to an appreciable fall in prices for oil and other commodities and slackening activity in the shipping industry. In the same way that Norway has benefited strongly from the sharp international upswing in recent years, the Norwegian economy could be relatively hard-hit by such a downturn. For example, activity in the petroleum industry might decline considerably.

The change in China's exchange rate regime and the revaluation of the Chinese currency by 2 per cent will probably not cause substantial changes in the imbalances in world trade. However, the gradual occurrence of major changes in the same direction cannot be ruled out. This would reduce demand for the US dollar. Subsequent developments will depend in part on whether the fall in demand for the US dollar is abrupt or gradual.

Structural changes in world trade have been important for the Norwegian economy, not least for the rise in prices for imported goods and services. The shift in imports towards low-cost countries has come gradually since 2001. In the *Inflation Report* projections, we assume that the import pattern will gradually become more stable. If the shift continues, the price-dampening effects of increased imports from low-cost countries in Asia and Central and Eastern Europe will persist longer than assumed.

The change in China's exchange rate regime and the revaluation of the Chinese currency will probably not cause noticeable changes in price developments for imported consumer goods.

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. In the first half of this year, the price of Brent Blend has generally fluctuated between USD 45 and USD 55 per barrel. Oil prices have risen further this summer and have been more than USD 60 per barrel in August.

Prices for oil futures have also increased.

Rising or persistently high oil prices may gradually dampen growth among our most important trading partners. The slowdown may occur gradually, and will not necessarily be particularly pronounced.

As long as oil prices remain high and there is robust growth in other parts of the world, as in China, other commodity prices and shipping activity will remain buoyant. Activity may then remain high in key sectors of the Norwegian economy, such as petroleum-related industries and the shipbuilding industry. At the same time, higher oil prices and lower external interest rates may, other things being equal, lead to an appreciation of the Norwegian krone, which will contribute to keeping domestic inflation low. Over time, a strong krone and weak demand among major trading partner countries will probably have a dampening impact on activity in Norway.

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.

More on the oil market

The IMF has analysed supply and demand in the oil market for the period ahead in the latest issue of "World Economic Outlook", published in April of this year.

Assuming an annual global GDP growth of approximately 3 per cent and an oil price in line with market expectations in February 2005,[1] demand for oil is expected to increase by around 2 per cent per year until 2030. Price expectations are higher now, but according to IMF calculations, the demand for oil in the long-term reacts relatively little to price changes.

The growth in demand 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 in the not-too-distant future – in 5 years, according to IMF estimates. Higher demand will 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 satisfies any remaining demand by increasing its production capacity. Alternatively, OPEC can take a more active position and push up oil prices even further by restraining production.

Not many years ago, it was normal to assume that the long-term price of oil was around USD 20 to USD 25 (in real value) per barrel. Analyses such as the one presented by the IMF suggest that the long-term oil price level may be considerably higher than this.

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[1] An average of USD 45 per barrel in 2005 and falling to USD 34 per barrel in 2010 and the years following.

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 shipbuilding industry and the building and 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. At the same time, the rest of the Norwegian economy was experiencing an upturn. 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.

Monetary policy and the outlook for the Norwegian economy

The analyses in *Inflation Report* 2/05 are based on a baseline scenario where the key rate until 2007 follows forward interest rates, and then rises somewhat faster. Forward rates on 24 June indicated expectations that the key rate would increase to approximately 2¼ per cent towards the end of 2005 and to 2¾ per cent at the end of 2006. The krone exchange rate is assumed to shadow the forward exchange rate, which remains broadly unchanged over the next three years.

Capacity utilisation in the Norwegian economy is expected to increase this year and next and exceed its normal level. There are prospects that inflation will gradually pick up and be close to 2½ per cent at the three-year horizon. Monetary policy that gradually becomes less expansionary will stabilise the economy over time, thereby curbing inflation and preventing it from overshooting the target. New information since the publication of the last *Inflation Report* does not provide grounds for changing the assessment of developments in the real economy. Nor has there been any substantial change in the inflation outlook.

Monetary policy cannot fine-tune economic developments, but it can seek to hamper the most significant effects of disturbances to the economy.

The objectives of bringing inflation back to the target of 2½ per cent and anchoring inflation expectations imply a continued low interest rate. The krone exchange rate appreciated somewhat following the interest rate increase in June.

On the other hand, output growth is high. The objective of stabilising developments in output may, in isolation, imply a higher interest rate. High capacity utilisation may generate a continued sharp rise in property prices and household borrowing. This could be a source of instability in demand and output in the somewhat longer run.

The Executive Board’s assessment in the June *Inflation Report* was that the interest rate may gradually – in small, not too frequent steps – be brought up towards a more normal level if economic developments are approximately as projected in the Report. Such an interest rate path was considered to provide a reasonable balance between the objective of stabilising inflation at target and the objective of stabilising growth in output and employment. It was the Executive Board’s assessment that the sight deposit rate should lie in the interval 1¾ - 2¾ per cent in the period to the publication of the next *Inflation Report* on 2 November. At the monetary policy meeting of 30 June, the sight deposit rate was increased by ¼ percentage point to 2 per cent.

At the monetary policy meeting of 11 August, the Executive Board stated that new information since the previous monetary policy meeting does not suggest that we should deviate from the interest rate path envisaged in the June *Inflation Report*.

Monetary policy easing through 2003 and into 2004 has resulted in low real interest rates. Short-term real interest rates may now be considerably lower than the level that implies long-term balance in the economy – the neutral real interest rate. A low real interest rate, and expectations of a continued low real interest rate, will contribute to stimulating activity even after the effects of the interest rate fall unwind. Calculations may, on an uncertain basis, indicate that the neutral real interest rate for Norway lies between 2½ and 3½%. It has probably fallen somewhat in recent years.

Although the projections are based on rising real interest rates, the real interest rate will be lower than the neutral rate during the entire period. The monetary policy stance is therefore expansionary. So far, the effects do not appear to be stronger than expected, but we have little experience of such low interest rates. It is uncertain how quickly prices and wages will react when growth in output and employment picks up. There is also a risk that an interest rate that is kept low for a longer period may lead to expectations of a persistently low interest rate. This may involve a risk of persistently high capacity utilisation and inflation eventually overshooting the target.

Household debt has increased at a faster pace than income in the last ten years. Norges Bank's calculations indicate that the sharp rise in house prices in recent years may explain a large share of debt growth. Higher house prices have a fairly long-lasting effect on household debt growth. As a result, credit growth will remain high for a fairly long period even though the rise in house prices is expected to slow. Given the assumptions underlying our projections, it is likely that debt will continue to grow at a faster pace than disposable income through the entire projection period.

As a result of high credit growth, the household debt burden has increased over the past year. The debt burden is currently record high. Due to unusually low interest rates, the interest burden is, nevertheless, relatively low. A normalisation of interest rates will increase households' net interest expenses, but according to the projections the interest burden will not be higher than it was at the end of the 1990s. If there are expectations of persistently low interest rates, there is a risk that the debt burden may increase more than assumed in the projections. Net interest expenses will then also be higher than assumed. In addition, households will be vulnerable if unexpected disturbances result in higher than expected interest rates.

Challenges ahead

Oil gives us an economic base that is not available to many other countries. But it also presents us with many 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 will have an impact on competitiveness in Norwegian business and industry. A high level and wide fluctuations in the use of petroleum revenues will 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 shall not be 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 investments at home and abroad.

The fiscal rule for the budget implies that the government can use 4 per cent of the Fund over time. This year, around 6 per cent is being used. The deviation partly reflects an unexpected shortfall in tax revenues in recent years. The government budget deficit is the difference between total revenues and total expenditure. They each account for about half of total GDP in Norway. Even small deviations from expenditure and revenue projections can have a major impact on the deficit. Exchange rate changes will also lead to fluctuations in the value of the Petroleum Fund. For these reasons alone, the use of petroleum revenues may in periods deviate from the 4 per cent rule. Spending was also increased in response to the economic downturn. We can, therefore, safely affirm that the fiscal rule has been normative for fiscal policy.

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 2½ 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 2½ 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 immediately affect the domestic economy. The effect of higher oil prices will gradually be seen when the real return on the Fund measured in NOK increases. Thus, the government authorities will be able to budget a higher deficit in the years ahead. 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 wide 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 current social security rules, is increasing.

The return on the Petroleum Fund can only cover a small portion of the higher pension expenditure. According to Ministry of Finance calculations, funding needs equivalent to 6 per cent of GDP will still be uncovered in 2060 given an oil price of NOK 230 (2005 prices) or around USD 35 per barrel. Oil futures six to seven 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.

In May, the Storting (Norwegian parliament) deliberated the Pension Commission's proposals for reforming the national insurance system. There was agreement on the main points but the specific design remains. If we succeed in reducing the growth in pension expenditure through a modernised national insurance system and other reforms, this will be an important contribution to addressing the fiscal challenges we are facing.