Jarle Bergo: Household saving and the economic outlook

Speech by Mr Jarle Bergo, Deputy Governor of the Norges Bank (Central Bank of Norway), Oslo, 3 October 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 21 September, 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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Introduction

First of all, let me take the opportunity to thank you for your invitation to speak to you this morning.

Most of you in the audience today are in daily contact with the public to give them advice about saving and investment decisions. Some of these decisions can have considerable impact on a household's financial situation. In addition, overall developments in the economy are a result of all these individual decisions. In any case, it is important that all of these decisions are based on the best possible information.

Savings motive and forms of saving

One decision we take as individuals is how much of our current income we are not going to spend on consumption immediately. In other words – how much we are going to save. We can save directly in the form of fixed assets such as residential property or by investing in financial assets. Households that save in banks or invest in other forms of financial assets make funds available to others. Banks convert some households' savings into loans for other households wishing to finance house purchases, for instance. If we look at the household sector as a whole, savings accounted for about five per cent of household disposable income in 2004,[1] which has been the level of saving for the past few years. These are funds that are channelled to the business sector in Norway or abroad to finance investment there.

There may be various reasons behind a decision to save. In many cases, the objective is to spread consumption evenly through the course of a lifetime. Another reason may be the desire to leave behind an inheritance.

For most people, the level of income will fluctuate through life. Most of our income is earned while we are economically active. Once our working career is over, we will have little to live on if we have not set aside capital as we earn or have secured our retirement by some other means. A hundred years ago, a common way of "saving" for old age was to have a large number of children. A large family increased the probability of some of the children growing up and being able to support their parents when they were old. By looking after family property, and perhaps expanding it, subsequent generations could also be provided for.

Demography is also important today, but the importance of a reasonable ratio of workers to pensioners has become somewhat less obvious because of the way we now try to ensure financial security in old age. It is probably no coincidence that the Norwegian expression for the end of our working career is "to withdraw with a pension". The equivalent expression in

[1] This figure has been adjusted for estimated extraordinary share dividends as from 2000.

English, “to retire”, means simply to withdraw. There are no associations with financial benefits.

In Norway, everyone is entitled to a state pension at the age of 67. How much each of us will receive depends both on the size of our income through our working career and on the path of growth in the economy. With its current structure, the National Insurance Scheme will be facing a considerable challenge in the future when an increasing proportion of the population is over 67 years old. Many employees receive an extra pension payment in the form of an occupational pension. In Norway, this will soon apply to virtually all employees.

Over the past few years, private pension insurance has become more common in Norway. In 2004, individual pension agreements had increased by 13 per cent since 1997. Membership in collective pension schemes increased by 22 per cent in the same period. It is likely that the debate around the state pension system has in some cases generated concern about how much the National Insurance Scheme will provide. The same debate may have led others to discover the exact size of the payments they can expect to receive as pensioners. As income levels rise, many will want to set aside more of their income for consumption later in life. In addition, today’s working population expects to live longer than previous generations, but also to be more active and in better shape than they were. Many people will therefore want to have more capital at their disposal as pensioners than public pension schemes can provide.

Another reason to save is to have something put by to meet emergencies. In Norway, the tradition used to be to hide away some extra “daler” in savings in the bottom of a trunk. These emergencies are also to a greater extent now covered by public schemes such as unemployment benefit and disability pensions. At the same time, private schemes are becoming more common.

Let us now look at how households save. Households save either in the form of fixed investment, mainly their own homes, or in the form of financial investments. This chart shows how households distribute their total wealth. The value of housing wealth is very uncertain. By our estimates, households’ total housing wealth was around NOK 2000 billion at the end of 2004. Housing wealth accounted for a little more than half of total gross household wealth at this time. The picture was about the same in the mid-1990s.

If we look more closely at household financial wealth, we find that it is spread over various assets, with insurance claims the most important at the end of 2004. By paying premiums into various insurance schemes, mainly life and pension insurance, households earn the right to future disbursements from the insurance companies. These premiums accounted for more than a third of household financial wealth at the end of 2004. The investment instruments perhaps most commonly referred to, securities and bank deposits, accounted for less than a quarter of total wealth.

Household gross financial wealth must be seen in the context of the debt accumulated by households as a group. Even when this is taken into account, the household sector as a whole has positive net financial wealth.

As a share of disposable income, household net financial wealth increased from the end of the 1980s to the mid-1990s. In relation to disposable income, debt was reduced, while household wealth increased. From the end of the 1990s, household debt and wealth have risen in tandem. Net wealth has remained fairly stable at around 50 per cent of disposable income. The rise in household debt must be seen in the context of the strong rise in house prices.

From oil to financial wealth

Household saving is part of the country’s total saving. As a nation, we can save by investing in fixed assets in Norway or by making financial investments abroad. Domestic fixed investment provides a return in the form of higher production capacity in the future. Building up financial assets abroad allows us to pay for more imports in the years ahead.

In the past few years, there has been a sharp increase in Norway's saving, as conventionally measured in the national accounts. As a share of GDP, Norway's saving after the turn of this century has been almost double the average for the 1980s and 1990s.

The explanation for these figures lies in the Government Petroleum Fund. Norway's petroleum resources are in principle part of our national wealth, but are not recorded as such in the national accounts. When oil is extracted and sold, natural assets are transformed into financial wealth. As long as this financial wealth continues to grow, it will appear as government saving in the accounts, while it is in reality a conversion of wealth. In this sense, we are not saving so much more than we used to. Nevertheless - when households see that the state, which has undertaken substantial pension obligations, puts money aside, some may perceive this as a guarantee for their own pensions. This may influence their own private saving decisions.

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 higher pension expenditure. The chart shows how pension expenditure and the real return on the Petroleum Fund will develop in the years to 2060. The calculations were carried out by the Ministry of Finance and based on a long-term oil price of 180 2004-kroner (around USD 27). Even with a long-term oil price of 230 2004-kroner (around USD 35), a funding requirement equivalent to 6 per cent of GDP will still not be covered in 2060. Oil futures six to seven years ahead are now higher than this. If oil prices remain as high in the future, the funding requirement will be somewhat lower. To base decisions on this, however, would be a very risky strategy.

The economic outlook

The size of the return on our savings, at the national or the personal level, will depend on how well we have invested, but also on economic developments. For our pensions, it is important that wealth creation is substantial in the years ahead.

It is natural for me to focus on how monetary policy can contribute to high wealth creation.

Monetary policy in Norway is oriented towards low and stable inflation. This is the most important contribution monetary policy can make to sound economic developments in the long term. Low and stable inflation provides the economy with a nominal anchor. This contributes to predictability for those taking decisions about saving and investment today, although the result depends on how the economy develops in the future. In addition, we will seek to prevent unduly wide fluctuations in output and employment in the short and medium term.

In the long term, output in an economy is determined by the supply of labour, capital and technology.

Monetary policy influences the economy with long and variable lags. This means we must look ahead when setting interest rates. I would therefore like to comment briefly on our assessment for the next three years, based on the analyses in the most recent Inflation Report, published in June (Inflation Report 2/05).

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 interest rate reductions through 2003 and into 2004 have 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.

Monetary policy easing 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.

The economic upturn has continued 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. In service industries and the construction sector, continued low interest rates and strong growth in household demand are expected to result in a further increase in activity in the near term. Capacity utilisation in the Norwegian economy now appears to be 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 in increasing production.

The situation in the labour market does not indicate that substantial pressures are building up 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 modest in relation to output growth. This may be due to lagged effects of the sharp fall in sickness absence through 2004. In many companies, the large increase in available person-hours was probably not fully utilised immediately. A considerable share of production growth so far this year may be the result of improved utilisation of existing company workforces. In addition, the use of foreign labour seems to have increased recently.

Inflation decelerated markedly from summer 2003 and continued to fall in the beginning of 2004. Consumer price inflation has subsequently picked up, albeit at a gentle pace. In August, the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products was 1.3 per cent.

Prices for imported consumer goods have continued to fall. The decline in prices may reflect high productivity growth in the production of some goods and large investments to increase production capacity, particularly in China.

Prices for domestically produced goods and services rose by 2.1 per cent in the twelve months to August this year.

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. Low wage growth will contribute to curbing the rise in prices for domestically produced goods and services.

Economic growth among trading partners is expected to be somewhat lower this year than in 2004. In the years ahead, growth is expected to 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.

Very high growth in demand for oil is one of the factors behind record high oil prices. In the first half of this year, the price of Brent Blend fluctuated for the most part between USD 45 and USD 55 per barrel. Oil prices rose further this summer, exceeding USD 60 per barrel in August and September. 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.

Rising or persistently high oil prices may gradually dampen growth among our most important trading partners. The slowdown may occur gradually and may not be particularly marked, but there are now growing concerns that high oil prices may have a stronger impact on inflation and inflation expectations. Monetary policy easing in response to this may then trigger a more pronounced downturn.

High oil prices have a different impact in Norway than in oil-importing countries. A rise in oil prices improves our terms of trade. Other countries perceive this as an externally imposed tax.

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 analyses in Inflation Report 2/05 are based on a baseline scenario where the key rate shadows forward interest rates up to 2007, and then rises somewhat more rapidly. The krone exchange rate is assumed to shadow the forward exchange rate, which remains broadly unchanged over the next three years.

Private consumption accounts for just under 60 per cent of total demand in mainland Norway, and is an important channel through which monetary policy operates.

Low real interest rates, solid growth in real disposable income and a continued sharp rise in house prices will result in high growth in private consumption again this year. Higher employment and somewhat higher wage growth will continue to contribute to growth in household demand in the period ahead. Household debt, however, has risen sharply. A gradual normalisation of interest rates will reduce growth in household disposable income. This suggests lower growth in consumption. We assume that households will choose to spread consumption over time, so that the saving ratio will continue to fall even if interest rates rise.

Housing investment rose sharply last year. It appears that growth in residential construction will remain high this year, although the rate of growth is expected to slow somewhat through the year. Low interest rates may have contributed to moving forward some housing projects. A gradual normalisation of interest rates implies more moderate growth in housing investment. Developments in underlying demand for housing may also imply that residential construction will stabilise and gradually decline somewhat.

Household debt has increased at a faster pace than income over the past ten years. Norges Bank’s calculations indicate that debt growth may largely be due to the sharp rise in house prices in recent years. Higher house prices have a fairly prolonged 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.

High credit growth has led to a rise in the household debt burden, measured as loan debt as a percentage of liquid disposable income. The debt burden, measured in this way, is now 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 debt may increase more than assumed. Net interest expenses and the debt burden will then also be higher than assumed. In addition, households will be vulnerable if unexpected disturbances result in higher-than-expected interest rates.

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. Since the publication of the June Inflation Report, prices for domestically produced consumer goods have risen slightly less than expected. At the same time, oil prices have been somewhat higher than assumed. Energy prices are pushing up consumer price inflation.

New information since the publication of the June Inflation Report does not provide grounds for changing the assessment of developments in the real economy. Growth among trading partners seems on the whole to be approximately as expected in the June Inflation Report, but the risk of more sluggish developments has increased, according to the IMF and the OECD. High oil prices may result in somewhat higher global inflation than previously projected.

The objectives of bringing inflation back to the target of 2.5 per cent and anchoring inflation expectations imply a continued low interest rate.

On the other hand, there are expectations that high output growth will persist. The objective of stabilising developments in output may, in isolation, imply a higher interest rate. Inflation is gradually picking up. 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 2005 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. This 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.

Following the monetary policy meeting on 21 September, the Executive Board stated that developments in output, demand and underlying inflation had been consistent with the projections in the June Inflation Report. The Executive Board also stated that its monetary policy strategy and assessments indicate that the interest rate should be gradually increased ahead. One option was to increase the interest rate at this meeting, but the Executive Board found it appropriate to leave the interest rate unchanged.

Conclusion

In my speech today, I have focused on how much and in what way households save and on the prospects for wealth creation. I have also pointed to the challenge facing our current pension system as an ever increasing share of the population gradually reaches retirement age. Increased saving today may be a way to address this challenge, but this is not enough in itself. In the long term, the most important factor will be how we manage our national wealth.

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 some of the main points, but the specific content has yet to be determined. If we succeed in reducing the growth in pension expenditure by modernising the national insurance system and introducing other reforms, this will be an important step towards addressing the fiscal challenges facing us.