Svein Gjedrem: The economic outlook

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Oslo, 6 April 2006.

The address 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 1/06 and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

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

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Excellencies, Ladies and Gentlemen,

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

Increased globalization

The last decade has been characterized by increasing economic integration and considerable changes in the international division of labour. Global trade is growing at a markedly faster pace than production, thanks to technological advances and a sharp reduction in the costs associated with trade in goods, services and information.

World financial markets are also in flux. Increased global trade and economic integration have led to a strong rise in cross-border capital flows. Foreign ownership of businesses has grown considerably. At the same time, savings are increasingly being invested in foreign countries. The world is gradually moving closer to becoming one market.

These changes have been made possible by trade liberalization in the post-war period. Through negotiations in the WTO, earlier on the GATT, agreements have been reached on removal of trade barriers, dismantling of tariff barriers, removal of subsidies, introduction of anti-dumping measures, and agreements have been entered into for textiles, agricultural products and other goods and services. Today, almost all countries participate as members or observers in these negotiations and the issues are far-ranging.

Political changes in many regions have amplified the tendency of increased globalization. Over the past few decades, China has changed course and is now a member of the WTO. Its share of total exports is growing rapidly. The countries within the Commonwealth of Independent States (CIS) have increased their exports markedly since the early 1990s. India is at the starting-line.

Many of these countries have large labour forces that offer their services at very low wages, and these labour resources are available to companies that compete on world markets. The working-age population in rural China for instance is nearly the same as that of the entire OECD area. Many are seeking new opportunities and work in the urban areas.

Low labour costs and more efficient transport and communication attract labour-intensive production. Production of goods and services is being transferred from Norway and other high-cost countries to amongst others the Baltic countries, Poland, China, India or other emerging economies.

There are many examples showing that competition in selling highly skilled services is also intensifying. Norwegians are offered myopia surgery in Turkey. Dental care and other medical services are also offered, at prices that are substantially lower than here. The Norwegian oil and gas company Norsk Hydro reports that almost 300 000 hours of engineering services for the natural gas field Ormen Lange were supplied by Indian engineers, located in India.

The shift in the division of labour is now influencing real wage growth in industrialised countries. The risk that a business will have to wind up operations or move abroad is dampening costs as bargaining power is being transferred from workers to employers. In a number of European countries, wage growth is also being influenced by labour inflows from the new EU member states.

Increased trade has engendered higher demand for shipping services and favourable freight rates for a period. This has in turn led to a boom in the shipbuilding industry. At the same time, high energy prices are boosting investment in the petroleum and electricity sectors, with considerable impetus to the engineering industry. Growth in Asia is also having a favourable impact on many metal prices.

Norway's terms of trade are improving. Prices for our imported goods are falling in relation to prices for goods we export. The impact of the rise in oil and gas prices is particularly strong, but the terms-of-trade gains for the mainland economy have also been high.

The situation in Norway differs from that of its Nordic neighbouring countries. Sales of Swedish and Finnish high-tech products are growing strongly in volume terms, but prices are falling. Denmark has a diversified business sector, which is overall moving on a steady path.

Strong development in the petroleum sector

High oil prices have provided a strong impetus for the petroleum industry and have led to a strong increase in activity on the Norwegian continental shelf. Many projects have been launched to increase recovery from fields in operation, and investment in the petroleum sector has increased sharply. The large development projects relating to the natural gas fields Snøhvit outside of Hammerfest and Ormen Lange at Aukra have made a large contribution to the high level of investment. Both these projects also involve considerable onshore development, which may have generated stronger impulses to the business sector locally than pure offshore projects. Investment activity associated with these two gas fields will probably decline in the period to completion in 2007.

Production has reached record levels and is expected to remain high for some years, a continued high activity level is anticipated, and many new development projects are being considered by the authorities.

The oil age in Norway has spanned 30 years and it appears that it will continue for many years ahead. Our petroleum resources can be divided into three, of which approximately 1/3 has been produced by now, 1/3 has been found but not produced, and 1/3 remains to be found.

The Norwegian authorities have been successful in ensuring that the bulk of the petroleum wealth benefits society as a whole. Both the state's ownership interests through the State's Direct Financial Interest in petroleum activities (SDFI) and the tax system have contributed. The companies that extract oil earn a reasonable return on their investments and have incentives to invest, but the economic rent has essentially accrued to the general public.

The authorities have so far also been successful in smoothing the use of petroleum revenues over time. This is important for several reasons. First, it is misleading to look upon the cash flow from petroleum activities as income. The appropriate economic perspective is to see the transfer of cash flow to investments abroad as a way of transferring capital from one account to another – from petroleum to foreign securities. By doing so, we diversify risk.

Second, the size of the cash flow from petroleum activities varies. If petroleum revenues were to be used as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy.

Third, the use of petroleum revenues has an impact on competitiveness in Norwegian business and industry. A high level and substantial variations in the use of petroleum revenues would have a negative impact on internationally exposed industries.

The establishment of the Government Pension Fund and the spending guidelines for petroleum revenues are intended to meet these challenges.

High oil and gas production and high prices, combined with high returns, have resulted in the value of the Government Pension Fund rising rapidly in recent years. The Fund is approaching the nominal value of one year's GDP and may reach two in the course of the next decade. This is based on the assumption that oil prices remain high over the next few years and then fall to about USD 30 per barrel.

The government bases its withdrawals from the Pension Fund on an average real return of 4 per cent for financing current expenditure. Given this spending rule, the return may come to finance more than 15 per cent of government expenditure in 10 years. We thus reap considerable benefits from managing our petroleum wealth well. The return represents future income that we forego if we draw on this wealth today. But even with this source of income, more than 80 per cent of expenditure must be covered by other sources. Financing the large pension payments that will have to be disbursed in the coming decades will be very demanding in any event.

The Pension Fund has a prudent investment strategy, with broad risk diversification, and a real return of 4 per cent is expected in the long term. There are examples of companies and investors that achieve a considerably higher return on capital over time. However, it is important to remember that for each successful investor earning high returns, there are many others with the same ambition and risk willingness, but with a record of poorer performance and bankruptcies. The Government Pension Fund cannot run the risk of ending up among the worst performers.

The globalisation of financial markets provides the Fund with good opportunities for investing and diversifying risk. However, we cannot insulate the Fund from wide annual swings in the value of the investments. We invest in international equity markets where prices fluctuate widely. These fluctuations are the reason why equity investments generate a higher return over time. The best year in the Fund's history so far was 2003, when it posted a real return of 11 per cent. This stood in sharp contrast to the previous year's result, which was -6 per cent.

Globalization and cyclical developments have been kind to the Norwegian economy. Few countries are benefiting as much as Norway – and losing as little – in the current environment of freer trade in goods and services and cross-border labour mobility.

Economic developments and prospects

Let me now turn to the current economic situation and the outlook for the years ahead.

Economic growth in Norway has generally been strong over the past 15 years, although with some cyclical variations. A clear upturn in the years from 1993 to 1998 was followed by a period of more moderate growth and a mild downturn in 2002 and into 2003.

Wage developments reflect and influence business cycles. Strong employment growth in the 1990s resulted in a rise in labour costs, which in turn had a dampening impact on growth. Moderate wage growth in recent years is being accompanied by a strong cyclical upturn since summer 2003.

The expansion has gradually broadened. Low interest rates have contributed to a relatively sharp rise in household demand throughout the upturn. At the same time, solid global growth has led to increased demand for many Norwegian export goods and high prices. Fixed investment in the petroleum sector has increased sharply, resulting in growing demand for goods and services supplied by mainland enterprises. Mainland fixed investment has also picked up.

The Norwegian economy has continued to exhibit high growth this year. So far in the economic upturn, the mainland economy has grown by an average of about 3.5 per cent quarterly, measured as an annualised rate.

Thus far, a substantial share of output growth has been attributable to strong growth in person-hours worked. It has taken time for employment to pick up, but this is occurring now. The labour supply and production equipment set a limit in the short term on the level of production in Norwegian enterprises. When production approaches this limit, wage and price inflation will pick up.

Our assessment of total capacity utilisation in the economy is reflected in our estimate for the output gap. The output gap is defined as the percentage difference between actual output and potential output. Potential output indicates the level of output that is consistent with price and cost stability. Output has increased more rapidly than potential output for 2-3 years. Much of the available capacity has now been put to use. We estimate that capacity utilisation was approximately ½ per cent above normal at end-2005.

Despite strong economic growth, inflation is still low. As the recovery became more broadly based, inflation gradually began to edge higher. In the second half of 2005, the 12-month rise in consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) varied between 1 and 1½ per cent, before surprising on the downside in December and January. In February, inflation edged up again. Monthly variations in this measure of core inflation have been fairly pronounced recently.

The trend in prices for consumer goods over the past two or three years is a result of favourable developments in the Norwegian and global economies. Low inflation is being accompanied by real income growth and a rise in production. In other words, low inflation is not the result of declining demand, activity or employment.

Growth among our trading partners is still solid, and appears on the whole to be somewhat stronger than assumed a few months ago. High commodity prices have contributed to somewhat higher inflation, but so far underlying inflation has not been pushed up. Key rates remain low among many of our trading partners. Market participants expect a gradual increase in key rates in the period ahead, both in Sweden and the euro area. In the US, the key rate is expected to increase by a further 50 basis points before peaking. In the UK, the key rate is expected to remain virtually unchanged in the period ahead.

Interest rate developments and buoyant growth have led to a sharp rise in credit growth in the past few years. Property and equity prices are also rising sharply in many countries, including Norway.

Debt developments in Norway through the 1990s can probably be viewed to some extent as a delayed adaptation to the deregulation of the housing and credit markets in the 1980s, after many households burned their fingers immediately after the deregulation. At the same time, the credit market has deepened. New loan products have emerged, and it is easier to raise loans. Borrowers can choose their repayment schedule. Credit and housing market liberalisation provides homebuyers with the opportunity to establish a high housing standard early in their adult lives and draw on this capital later in life. In recent years, household income growth has been solid, household confidence regarding the future has been strong and households probably perceive higher income levels as permanent. This may have resulted in a further rise in house prices and debt. In addition, low real interest rates are currently contributing to this.

Based on the backdrop of the economic development and the outlook for continued high energy prices ahead, a mechanical application of the 4 per cent fiscal rule implies that the use of petroleum revenues will increase by more than NOK 31 billion from 2006 to 2009. With continued solid growth in the Norwegian economy, it would be in line with the fiscal rule if the use of petroleum revenues is lower than the expected real return on the Government Petroleum Fund – Global over a few years.

We estimate an approximately unchanged structural non-oil deficit in 2007, and assume that fiscal policy will provide some stimulus to aggregate demand and output in 2008 and 2009, but somewhat less than a mechanical application of the fiscal rule based on our oil price assumption would imply.

The authorities conduct fiscal policy knowing how monetary policy will react. Today's flexible inflation targeting regime, giving weight to both variability in inflation and variability in output and employment, establishes a firm framework for monetary policy and provides clear guidelines on how monetary policy is to respond in different situations.

Monetary policy in Norway is oriented towards low and stable inflation, with annual consumer price inflation of close to 2.5 per cent over time. Flexible inflation targeting builds a bridge between the long-term objective of monetary policy, which is to keep inflation on target and provide an anchor for inflation expectations, and the more short-term objective of stability in the real economy.

This contributes to predictability for those who take decisions about saving and investment today, although the result of those decisions depends on how the economy develops in the future.

Monetary policy must strike a balance between the various objectives. Strong growth in the Norwegian economy, a tighter labour market, a pronounced rise in equity prices and high credit growth must be weighed against unexpectedly low inflation.

Norges Bank's projections in the *Inflation Report* are based on an interest rate path that in the Executive Board's assessment strikes a reasonable balance between the objectives of monetary policy. Previously, we based our analysis on various technical assumptions concerning future interest rates. One such assumption was market interest rate expectations. As from late last year, we now base our projections on an interest rate path that we consider reasonable. This gives Norges Bank more active ownership of the projections that are presented and of the uncertainty we believe surrounds these projections.

In the baseline scenario presented in *Inflation Report* 1/06, interest rates in Norway and abroad are assumed to rise somewhat faster in the longer term than current forward rates may imply. Exchange rate movements are difficult to project. The interest rate path at home and abroad may be consistent with an approximately unchanged krone exchange rate.

The high growth rate in the economy implies a gradual pick-up in price and cost inflation. With interest rate developments as outlined above, core inflation is projected to increase from about 1¼ per cent today to about 2 per cent at the end of 2007. There are prospects of a further increase in inflation, with inflation projected to be close to the target of 2.5 per cent three years ahead. The output gap is expected to increase over the next two years, but will peak at a fairly moderate level as gradual increases in the interest rate dampen demand growth.

On the basis of the analysis in the *Inflation Report*s, Norges Bank's Executive Board assesses the consequences for future interest rate development and adopts a monetary policy strategy for the period to the next Report.

Interest-rate setting since last summer has been oriented towards a gradual increase in the interest rate – in small, not too frequent steps – towards a more normal level. Based on Norges Bank's assessment of the driving forces in the economy, this strategy appears robust. Output growth is strong and the labour market is becoming tighter more quickly than expected. Higher growth in the economy may in isolation suggest a faster increase in the interest rate ahead. This would reduce the risk of bottlenecks in the economy, with rising cost inflation and continued debt build-up. On the other hand, the objective of bringing inflation up towards the target and anchoring inflation expectations argues for restraint in the upward movement of interest rates.

Norges Bank's Executive Board decided at its meeting on 16 March to raise the sight deposit rate by 0.25 percentage point to 2.50 per cent. The current assessment indicates an interest rate path where the interest rate is raised by about 1 percentage point this year, in line with expectations in the market. The sight deposit rate should be in the interval 2¼ – 3¼ per cent in the period to the publication of the next *Inflation Report* on 29 June 2006, conditional on economic developments that are broadly in line with the projections.

Uncertainty surrounding the interest rate reflects the monetary policy response to unexpected disturbances to inflation, output and the exchange rate. We have illustrated the uncertainty surrounding forecasts for the interest rate, inflation and the output gap with fan charts. The width of the fan charts is based on historical disturbances. However, there is no certainty that future disturbances will be of the same nature and scale. The wider the fan charts are, the more uncertain the projections.

Conclusion

Increased globalization and the ensuing terms of trade improvements have exposed the Norwegian economy to a significant upward income shock. This has magnified the domestic upswing.

So far, however, strong growth impulses have not led to major imbalances or strong upward price pressures.

This may be seen as an indication that the macroeconomic framework, most notably the fiscal and monetary policy regimes, has been quite successful so far in shielding the Norwegian economy from excessive fluctuations. More importantly, while we adhere to the macroeconomic framework it will shield the economy when oil prices fall and our terms of trade are reversed.

Thank you for your attention!