Svein Gjedrem: The economic outlook and monetary policy

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), for Norges Bank's regional network, Oslo, 9 November 2006.

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 1 November and Inflation Report 3/06.

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

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The economic situation

The world economy is currently experiencing its strongest continuous upturn since the early 1970s. This has contributed to solid growth in the Norwegian economy. Norway's terms of trade have improved by nearly 30% since 2000, and activity in the export industry is very high. Globalisation has resulted in a low rise in prices for imported consumer goods at the same time as strong growth in demand for commodities and semi-finished goods has led to high prices for many Norwegian export goods. The terms of trade for traditional goods and services have also improved, albeit to a lesser degree than for overall trade.

So far in the cyclical upturn, the mainland economy has grown by an average of close to 4 per cent annually. Current information about economic developments indicates that the cyclical upturn is continuing. Corporate sector profitability is solid. Companies are borrowing and investing. There is strong growth in employment, unemployment has fallen markedly, and household demand continues to rise. Capacity utilisation in the business sector is high and a growing number of enterprises are now facing constraints.

Statistics Norway's business tendency survey for the third quarter shows that Norwegian manufacturing is optimistic about the prospects ahead. A clear majority of industrial leaders assess the general outlook as more positive in the short-term than in the third quarter. A majority of industrial leaders are considering an increase in investment. A shortage of skilled labour is posing a mounting challenge to manufacturing in the period ahead.

This picture is consistent with information from the company contacts in Norges Bank's regional network. In the August round of interviews, 59 per cent of the companies reported capacity problems, and this share has increased since the previous round.

Output and employment are increasing in all sectors. Pressures are particularly strong in the building and construction sector and some corporate services. The rise in prices is moderate in retail trade. It also appears that extensive use of foreign contract labour, particularly in some manufacturing sectors and building and construction, is curbing wage growth.

An increasing number of our company contacts report labour shortages, particularly a shortage of engineers, project managers, transport workers and skilled labour in corporate services. Labour shortages are also beginning to emerge in retail trade and household services.

High demand for labour has resulted in a marked decline in unemployment so far this year. Unemployment is now in line with the unemployment level during the previous expansion at the end of the 1990s. Registered unemployment was 2.3 per cent of the labour force in October. Unemployment has declined for all occupational groups, and has been most pronounced in manufacturing, building and construction and the engineering and ICT sectors.

There are probably limitations to how much the supply of Norwegian labour can increase in the period ahead. Labour participation rates are high, particularly when taking into account demographic developments. Developments in the labour market are similar to those observed prior to the period of accelerating wage and cost inflation that started in 1998, but wage growth so far has been fairly moderate. Several factors may have contributed to this. An increase in inward labour migration and the opportunities provided by an international labour market may have prompted participants in local and centralised wage negotiations to place greater emphasis on the considerably higher wage level in Norway relative to our trading partners and on potential job vulnerability.

Foreign companies with contracts in Norway account for a substantial share of inward labour migration. Labour inflows from the new EU member states still appear to be growing, with the construction industry absorbing a particularly large share. In 2006, the number of persons employed from new EU member states who are not resident in Norway is estimated at close to 30 000, i.e. an increase of 12,000 since 2005. Inward labour migration has reduced bottlenecks in some industries. However, despite increased labour market flexibility, the risk of higher growth in labour costs is now rising.

Over the past six months, there have been increasing indications of labour shortages in the Norwegian economy. A rise in sickness absence and an increasing number of persons on disability benefits are pushing down production capacity this year. In view of the tightening taking place in the Swedish labour market, there may be reason to expect a reduction in the supply of labour from Sweden. Inward labour migration to Norway has taken place in a period with high unemployment in large parts of Europe. We have assumed that slower growth in the Norwegian economy and increased demand for labour in other parts of the Nordic region and in the new EU member states will gradually stabilise the number of foreign workers on short-term assignments in Norway.

In spite of solid corporate profitability and an unemployment level that has earlier triggered markedly higher wage growth, real wage growth from 2005 to 2006 will probably be moderate. Nevertheless, unemployment fell rapidly through the summer. The main agreements in the centralised wage settlements had then been concluded. The social partners may therefore have assumed that the labour market would be less tight than currently implied by employment and unemployment figures. Some groups negotiate wages locally in the autumn. Wage growth may be higher than average for these groups. Systematic information about these negotiations is limited, however, before the first months of 2007. In the last rounds of interviews with our regional network, an increasing number of companies reported that wage growth in 2006 will be higher than budgeted early this year.

The level of unemployment that is consistent with stable real wage growth is uncertain and probably varies over time. We have assumed that increased economic integration across countries, both in the form of an increase in inward labour migration and intensified competition in product markets, may have a dampening effect on wage demands for a given level of unemployment. In the period ahead, a tight labour market is expected to result in higher real wage growth. Nevertheless, it is assumed that labour inflows will have a dampening impact on wage demands, so that real wage growth will be a little lower in the next few years than in previous periods of equally low unemployment.

The upward pressure on price and wage inflation given the level of current resource utilisation, as reflected in the output gap, is estimated to be lower than in the previous expansion even though the unemployment rate is at approximately the same low level. This is due in part to high productivity growth in recent years.

Growth in disposable income has been high in recent years. Lower interest expenses and relatively high real wage growth have resulted in an increase in household purchasing power. The rise in house prices may also have fuelled growth in private consumption. With high growth in employment and falling unemployment, consumption growth is expected to be high in the period to the end of the year and into next year. As the interest rate level gradually normalises, household interest expenses will increase. Household interest-bearing debt is approximately NOK 1300 billion. According to our interest rate forecast, which I will return to later, the interest rate in 2008 will be more than 2 percentage points higher than in 2006. Such an interest rate increase will have a pre-tax effect on household income of roughly NOK 25 billion.

Combined with projected lower employment growth and higher inflation, this might reduce growth in household purchasing power in the years ahead. Higher wage growth would have the opposite effect. Overall, moderate growth in household purchasing power is expected to result in lower consumption growth in the period ahead.

A continued rise in house prices may contribute to sustaining consumption growth. House prices have increased further this autumn, and the twelve-month rise moved up to 18.2 per cent in October. Residential construction is still high. In 2005, the number of housing starts was the highest since the beginning of the 1980s. It appears that growth will be high again this year, but somewhat lower than in recent years. A number of contacts in Norges Bank's regional network report high demand for new dwellings, and order backlogs for residential construction are still exhibiting solid growth.

A gradual increase in the interest rate will probably curb activity in the housing market. Housing investment is expected to grow through this year, albeit less rapidly than last year. Housing investment growth will thereafter moderate further, and may fall somewhat towards the end of the projection period. House price inflation is expected to slow.

Household indebtedness has increased in tandem with high activity in the housing market. Growth in household debt (C2) has abated somewhat in recent months, but remains at a high level. Higher interest rates and lower house price inflation will curb growth in household debt in the next few years. Intensified competition and adaptation to new capital adequacy rules in the financial sector have squeezed banks' lending margins. This may have curbed the impact of higher policy rates on house price inflation.

Growth in credit to mainland enterprises has also shown a sharp increase over the past year, partly reflecting increased fixed investment. With prospects of continued high capacity utilisation in the Norwegian economy, solid profitability, ample liquidity and a high level of optimism among enterprises, strong growth in investment is expected again this year. As economic growth gradually slows, investment growth is also expected to moderate.

Property management companies account for nearly 40 per cent of banks' lending to the corporate sector. Activity in the commercial property market reached a very high level in 2005. The vacancy rate in Oslo has diminished steadily for two consecutive years and stood at 8 per cent in January 2006. In the course of 2005, office rental prices began to pick up in the largest Norwegian cities, with considerable variation within the various quality and location segments.

The rise in consumer prices has also edged up since the beginning of the cyclical upturn. The year-on-year rise in the consumer price index (CPI) was 2.6 per cent in September.

Energy products such as electricity and oil have put upward pressure on inflation over the past year. Electricity prices, including grid rent and taxes, were 48 per cent higher in August than one year earlier, while petrol prices were 1 per cent higher. Since the beginning of 2001, the rise in energy prices has been over 7 per cent on average.

Variations in energy prices may also lead to wide monthly variations in consumer price inflation. As a result of high electricity prices, the rise in CPI inflation will remain steady though 2006. Energy prices are expected to fall in the spring of 2007, dampening the rise in CPI inflation.

The rise in prices for non-energy goods has been moderate in recent years. Price impulses from imported consumer goods have been particularly weak. Their contribution to inflation has been negative virtually every year since the mid-1990s, partly reflecting increased trade, a shift in imports towards low-cost countries and a substantial improvement in distribution efficiency in Norway. Price impulses from imported consumer goods are expected to continue to exert downward pressure on inflation for some time ahead, albeit to a lesser extent than in previous years.

The rise in prices for domestically produced goods and services pushed up CPI inflation until this year, but since the beginning of the year this measure of inflation has edged down again. The 12-month rise in prices for goods and services produced in Norway, excluding energy, was 1.3 per cent in September. The reduction in day-care rates in January this year has pushed down domestic inflation by an estimated 0.3 per cent over the past year.

The rise in prices has been lower than expected for both goods and services. It seems that strong competition between various producers within the food industry and the construction industry has curbed inflation. In addition, productivity growth in retail trade has been high in the past few years. Intensified competition may also have restrained the rise in prices for banking and insurance services.

Continued strong competition, both foreign and domestic, and high productivity growth in recent years will probably contribute to curbing domestic inflation in 2007. Several factors, however, point to higher inflation in the period ahead, but the rise in prices will probably pick up somewhat later than the historical relationship between inflation and capacity utilisation in the economy would suggest.

Capacity utilisation in the Norwegian economy is picking up. This will contribute to a higher rise in prices for domestically produced goods and services. A tighter labour market will probably lead to higher wage growth in the coming years. There are also signs that productivity growth, which has been strong, will slow now, which must be expected when the cyclical upturn has lasted for a long period.

Driving forces ahead

The level of activity in the world economy is high. Global growth from 2004 to 2006 was the strongest recorded since the early 1970s. Continued solid growth among our trading partners is in prospect, and short-term interest rates are expected to rise in Sweden, Denmark, the UK and the euro area. After expanding at a strong pace over several years, the US economy is now showing signs of a slowdown.

Nevertheless, growth in the world economy is expected to remain firm. At the same time, the risk of an impending slowdown in global growth has increased. There are considerable uncertainties associated with the effect of a possible economic slowdown in the US on the global economy.

Signs of slower growth in the US are emerging primarily in the housing market. Historically, developments in the housing market have been closely related to the general pace of economic growth. Weaker developments in the housing market are expected to influence growth through a number of channels.

Lower house sales will curb housing investment, which accounts for a good 5 per cent of GDP. Residential construction has been important for employment in recent years. The turnover time has risen markedly and prices and housing starts have fallen.

High energy prices have so far pushed up inflation among our trading partners. In the US, general cost inflation has also been rising. In other countries, energy prices have only been passed on to a limited extent to other prices so that core inflation is still moderate and stable. The fall in oil prices through the autumn may curb inflation in the period ahead.

In isolation, lower energy prices might result in lower interest rates than otherwise and contribute more directly to growth in total demand in many countries. The price fall is related primarily to reduced uncertainty about the supply of oil. A number of the risk factors that pushed up oil prices this summer, such as the conflict in the Middle East and reduced production in Nigeria and the US, have been reduced. In addition, global oil stocks are high and OPEC has announced that they will reduce production, which will increase spare production capacity correspondingly. The fall in prices is also due in part to lower demand and increased supply of alternative energy sources following several years of high oil prices. In addition, slower growth in the US may reduce the pressure on prices for energy and other commodities.

Oil prices are of importance for the activity level in the Norwegian economy and for central government revenues. In spite of lower oil prices recently, Brent Blend futures prices may indicate that oil prices will remain high several years ahead. Nevertheless, it is important to be aware that futures prices do not provide particularly reliable indications about oil price developments. One to two years ahead, markets are thin and option prices indicate that market participants are very uncertain about future price developments.

High growth in the global economy has also pushed up prices for non-oil commodities. Rising commodity prices and buoyant activity in markets that are important for Norway have generated growth impulses to the Norwegian economy. Since May this year, commodity prices have varied widely, but on the whole have edged up since end-June.

Petroleum investment has reached a high level after three years of strong growth. Owing to large projects like Ormen Lange, Snøhvit and Statfjord late phase development, total investment may come to around NOK 100bn in 2006. The level of investment is assumed to remain high next year, before declining somewhat the following year when Ormen Lange and Snøhvit are scheduled for completion. Continued high oil prices are expected to contribute to high investment both in exploration and in fields in operation in the years ahead. The recent fall in oil prices will probably have little effect on investment plans. The price estimates underlying companies' investment decisions remain low compared with both spot and futures prices for oil.

Information from our regional network suggests that petroleum investment is providing considerable impulses to activity in Norway's coastal regions. According to the network, suppliers to the petroleum industry are expecting continued strong growth over the next few months. Statistic Norway's investment intensions survey for oil and gas activities confirms the impression of positive expectations for 2006 and 2007.

There are prospects of strong growth in the Government Pension Fund - Global. Given our assumption for oil price developments ahead (oil futures), spending in line with the expected real return on the Fund implies that the structural, non-oil deficit may increase by close to NOK 15 billion at 2006 prices in both 2008 and 2009. With a period of strong expansion in the Norwegian economy, somewhat lower petroleum revenue spending may be in line with the fiscal rule.

Strong growth in the Norwegian economy is boosting tax revenues and reducing spending on unemployment benefits. Over a three-year period, the economic turnaround has strengthened the budget by about NOK 30 billion. In the structural budget deficit, which is the basis for formulating fiscal policy, adjustments are made for such cyclical deviations. Fiscal policy that is expansionary during a downturn and contractionary when the economy is experiencing a boom has a stabilising effect.

Our projections are based on the assumption that the central government budget will generate some stimulus to total demand and output in 2008 and 2009, but somewhat less than the expected return on the Fund would imply.

The path for domestic and external interest rates does not imply considerable changes in the krone exchange rate. Neither the appreciation of the krone last spring, nor the depreciation this autumn can be explained to any appreciable extent by changes in interest rate expectations. Historically, the relationship between oil prices and the krone exchange rate has been unstable. In some periods, oil prices have been important for developments in the krone exchange rate, while in other periods there has been no clear relationship. In August, oil prices fell at the same time as the krone depreciated.

Interest rates are still low among many of our trading partners, in spite of the interest rate increases in several countries as a result of rising energy prices and higher consumer price inflation. In the November *Inflation Report*, Norges Bank assumes that money market rates among our trading partners will gradually increase over the next few years. Slower growth in the US has contributed to expectations that the rate tightening cycle is nearing an end and that the policy rate will be lowered in the course of next summer.

Our interest rate projections are based on the assumption that external and domestic interest rates will rise to a somewhat higher level in the longer term than implied by forward interest rates.

Monetary policy assessments and strategy

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. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment.

At Norges Bank's Executive Board meeting of 1 November, the sight deposit rate was raised by 0.25 percentage point to 3.25 per cent.

The Executive Board described the background for the decision as follows:

- Underlying inflation has been lower than projected in recent months. Nevertheless, several factors point to higher inflation ahead. Capacity utilisation is high and there is little spare capacity in the Norwegian economy. Employment is rapidly rising and unemployment has exhibited a marked decline. There are signs of higher wage growth and expectations of rising inflation. At the same time, the krone exchange rate has depreciated from strong values.
- The interest rate path presented in *Inflation Report 3/06* will provide a reasonable balance between the objective of bringing up inflation towards target and the objective of stabilising developments in output and employment, conditional on the information currently available to Norges Bank.
- Monetary policy influences the economy with a lag. Over several years, interest rates have been considerably lower than what Norges Bank considers to be a neutral level. The interest rate may gradually be raised to a more normal level at a somewhat faster pace than envisaged earlier, although it is unlikely that rates will be raised at every monetary policy meeting. Based on Norges Bank's current assessment, the interest rate will thus continue to be raised in small, not too frequent steps if economic developments are broadly in line with projections.
- The sight deposit rate should be in the interval 3¼ - 4¼ per cent in the period to the publication of the next *Inflation Report* on 15 March 2007, conditional on economic developments that are broadly in line with the projections. New information may reveal aspects of economic developments that indicate that the Norwegian economy is moving on a different path than projected. On the one hand, major shifts in trade patterns, strong competition, weaker global growth or a stronger krone exchange rate may result in low inflation. On the other hand, low real interest rates or a further depreciation of the krone may lead to a higher-than-projected rise in output and inflation.

Projections are uncertain. Disturbances in the economy will affect interest rate developments. This reduces the uncertainty about developments in prices and output.

Monetary policy cannot fine-tune economic developments, but it can prevent the largest effects from occurring when the economy is exposed to disturbances. In some situations, it may be appropriate to guard against particularly adverse developments. In the baseline scenario, the interest rate is gradually raised to a more normal level. Norges Bank continuously assesses the effects of interest rate changes and other new information concerning economic developments.

Thank you for your attention.