Svein Gjedrem: The economic outlook

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, Oslo, 31 March 2008.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 13 March, Monetary Policy Report 1/08 and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

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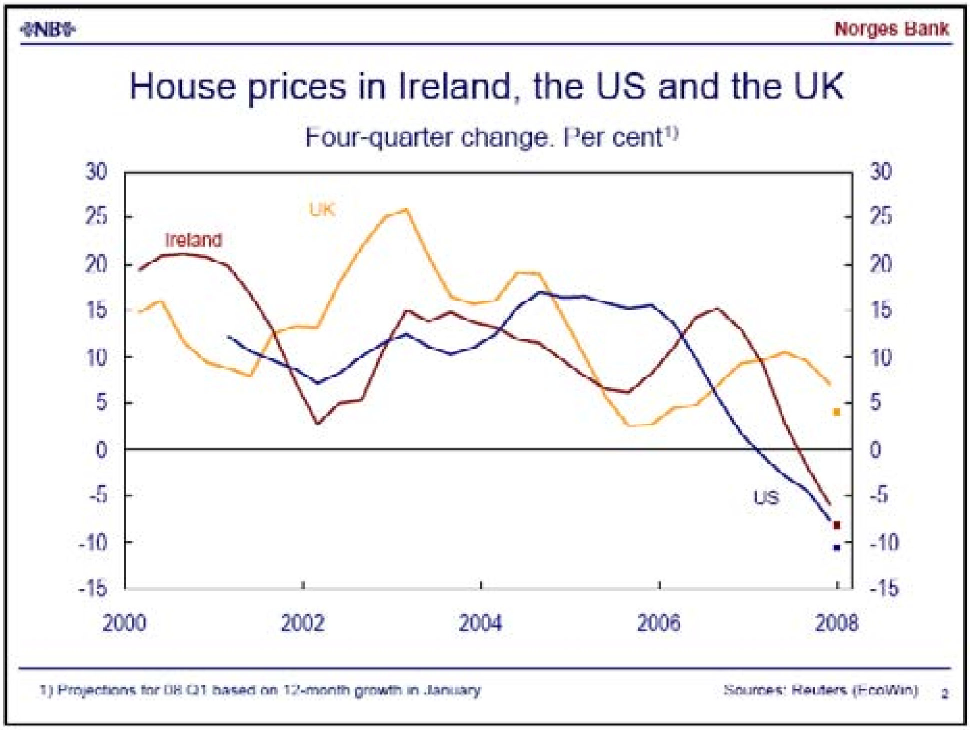
Excellencies, Ladies and Gentlemen,

Since our last meeting about a year ago, the international economic environment has changed quite dramatically. Starting in the US, turmoil in financial markets has quickly spread all over the world. The economic outlook for the US, and indeed the whole world, is weaker and a lot more uncertain than it was a year ago.

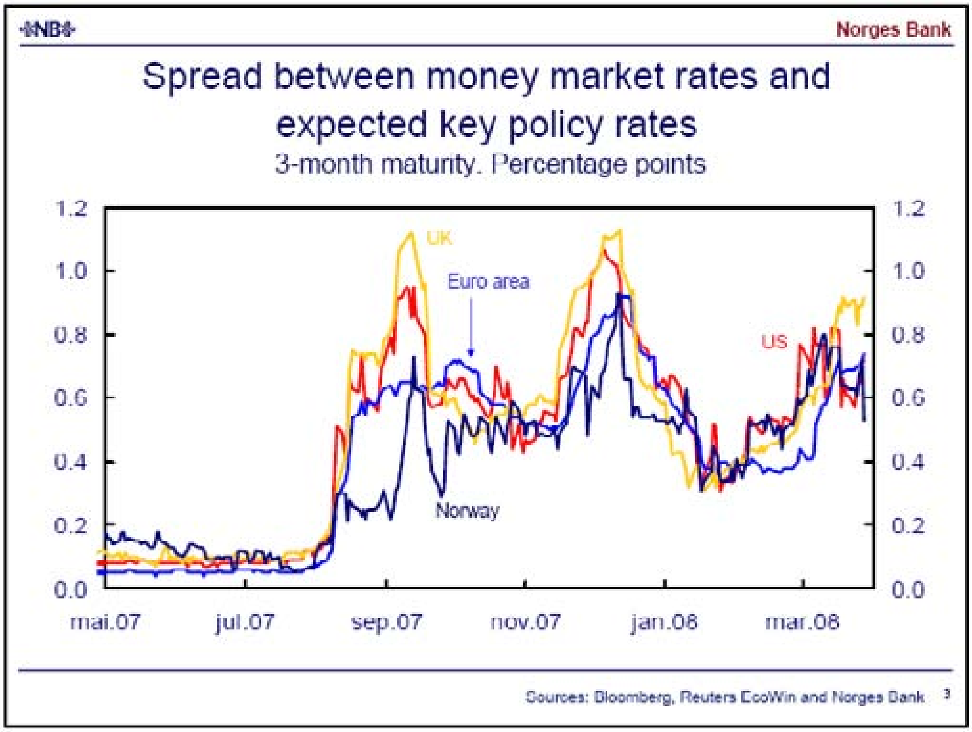
In my presentation today, I will discuss the effects of the turmoil on the Norwegian economy and the consequences it may have for international growth. I will also talk a little about the Government Pension Fund – Global in the context of the ongoing debate on sovereign wealth funds.

Continued turbulence in financial markets

The current turbulence in financial markets has its roots in high credit growth and reduced saving over the past decade, most notably in the US. Low interest rates and strong output growth triggered a sharp rise in house prices and housing investment.

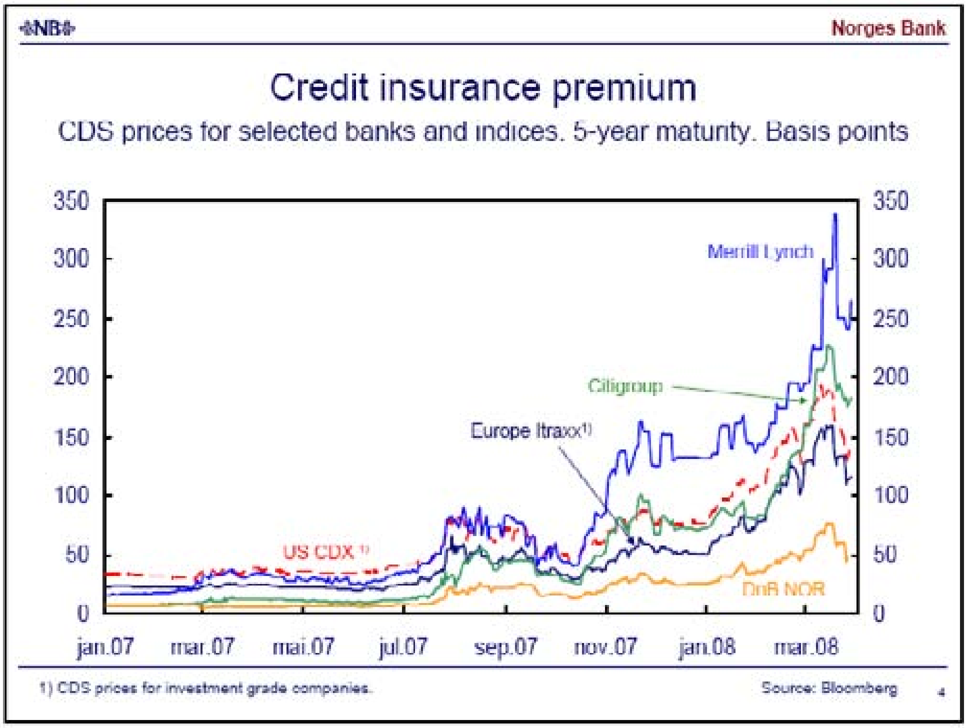


House prices in the US started to fall in 2006. There were reports of defaults on mortgage loans, but it was generally believed that the loans at risk were confined to a small segment of the US market. The first warning of more severe problems came in early 2007. And in the course of last summer, it became clear that the losses had spread. Other banks, funds and financial establishments in Europe, Asia and the US felt the turbulence.



The turmoil spread to money and credit markets in August last year. Few knew who was exposed to losses. Banks, funds and financial establishments started to question counterparties' financial situation, and held on to their money. This resulted in a surge in banks' premiums on short-term interbank rates. Moreover, banks had to bring back on their books loans from companies they had established. This further reduced their capacity and willingness to provide new loans.

When the interbank market seized up, many central banks injected extra liquidity. In periods, Norges Bank has also provided additional loans to banks. Liquidity injections have reduced swings and eased risk premiums in money markets. Nevertheless, the risk premiums are still high, especially for maturities from three months and longer.



As can be seen from this chart, credit risk surged towards the end of February, and is still markedly higher than in the latter part of 2007.

Norwegian companies and financial institutions have also been affected by the turmoil. Prices for credit insurance and funding costs have risen, although to a smaller extent than for many US and European institutions.

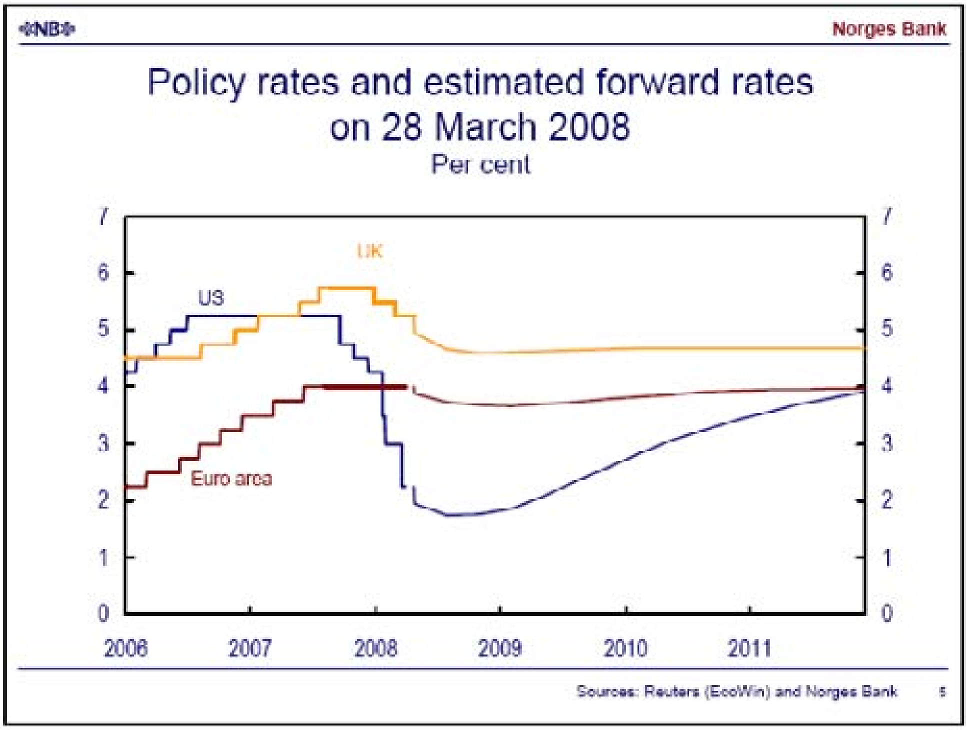
As a result, Norwegian banks now have to put more effort into procuring deposits and a little less into selling loans. Such a change in banks' behaviour may help to curb growth in demand and output in the period ahead.

In addition, there may be further repercussions for the Norwegian economy if weaker developments in the US lead to a broad-based pause in global growth.

First, a downturn in the world economy may have a negative impact on activity and profitability in export industries and perhaps even the oil sector. It may be more difficult to sell goods in a falling market, and prices for domestically produced goods may fall.

Second, turbulence and the prospect of weaker growth may increase uncertainty among Norwegian households and businesses. As a result, new projects and investments may be postponed, or enterprises may be reluctant to recruit new employees.

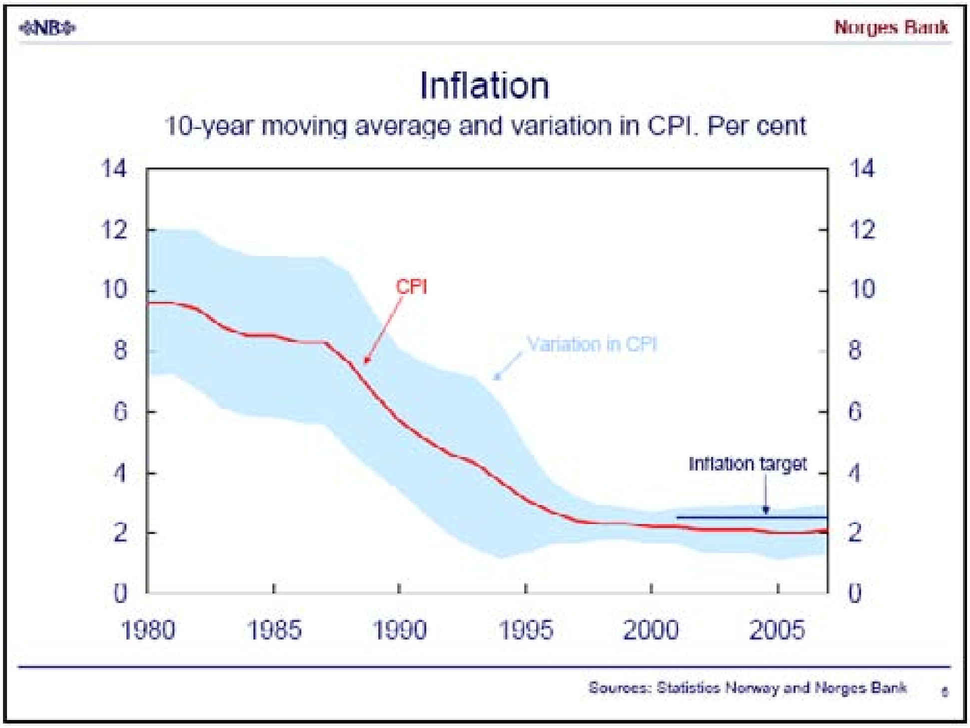
Third, the financial market turbulence has a more direct impact on the business sector. Banks and investors now apply a higher premium and higher prices for providing capital for acquisitions, restructuring and investment, and highly leveraged companies have to pay high loan risk premiums.



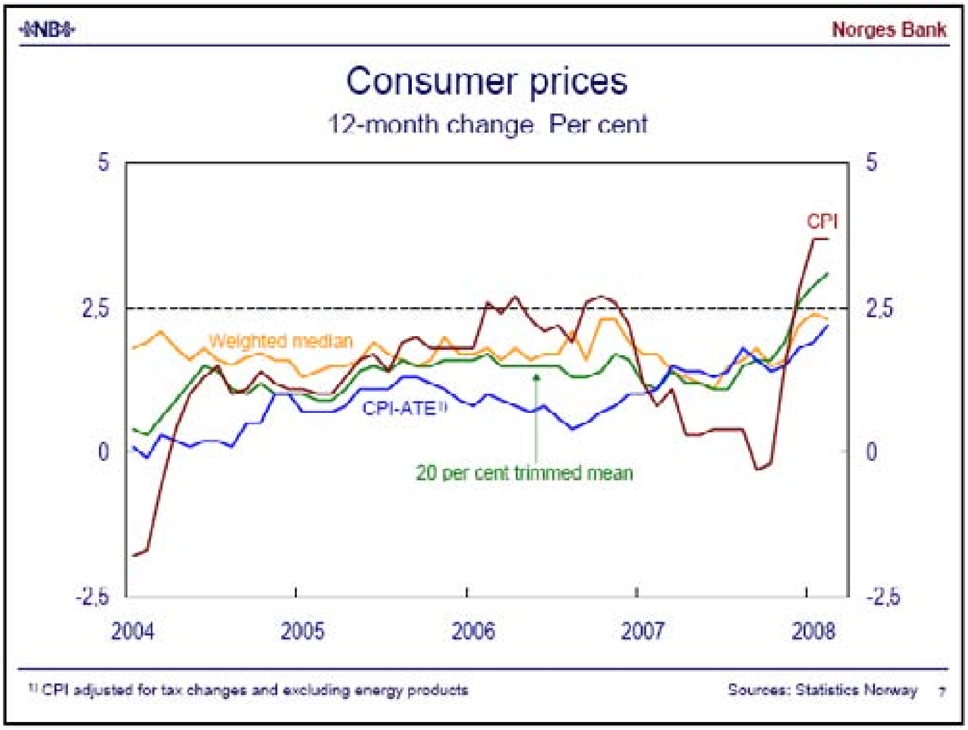
We still do not know what the full impact of the turbulence will be. The US authorities have taken measures, both fiscal and monetary, to address weaker growth prospects. Interest rates are shifting down in the US and many other countries. Money and financial market participants still expect considerably lower interest rates ahead than they did last autumn, particularly in the US, but also in Europe.

Norway – signs of easing growth and rising inflation

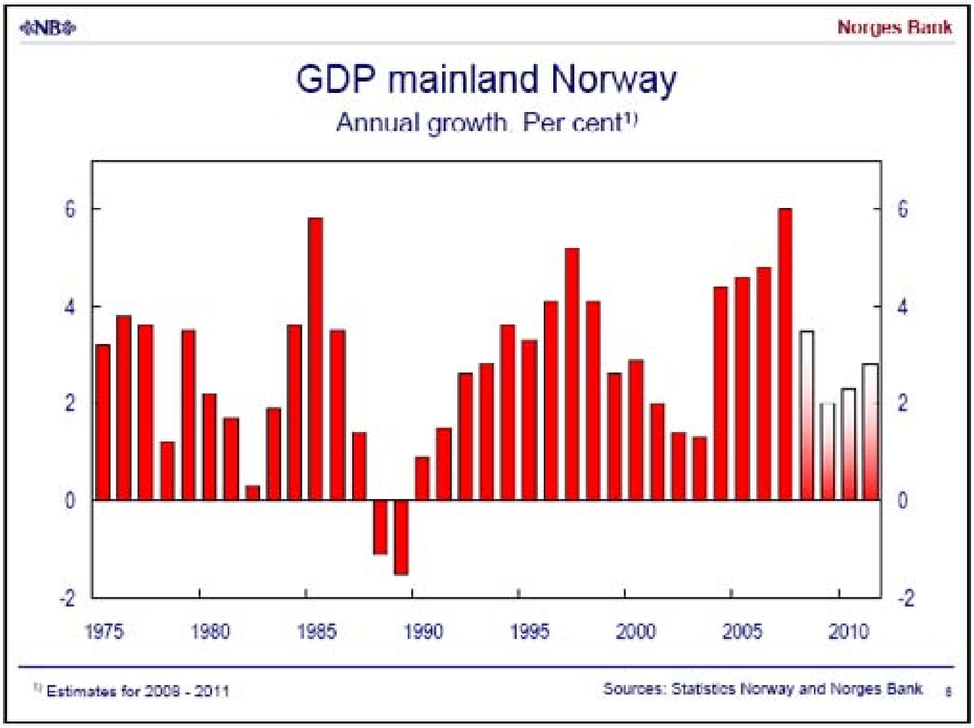
Let me now turn to economic developments and the outlook for the Norwegian economy.



Inflation in Norway has been low and stable since the mid-1990s. Over the past 5-10 years, inflation has been fairly close to, but somewhat lower than the operational target of consumer price inflation of close to 2.5 per cent over time.

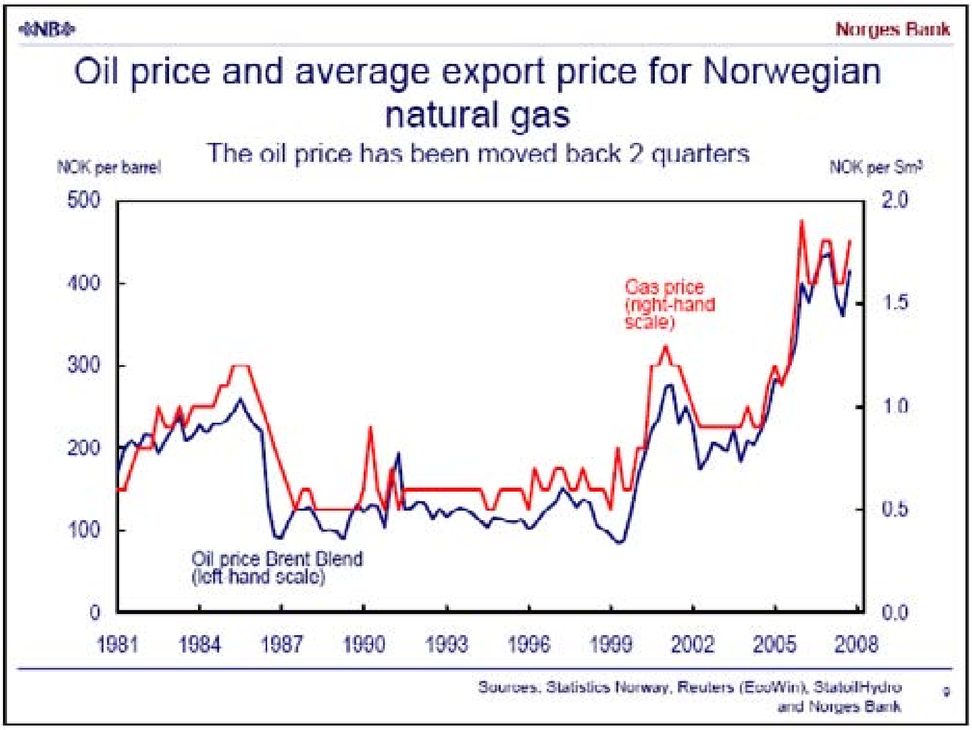


Recently, however, inflation has been on the increase. The year-on-year rise in consumer prices (CPI) picked up rapidly towards the end of 2007 and the first two months of 2008, reflecting an increase in electricity prices. Other measures of consumer price inflation have picked up as well. In February, the year-on-year rise in core inflation was 2.2 per cent. Prices for services and domestically produced goods, in particular some food products, have exhibited a particularly sharp rise. At the same time, prices for imported consumer goods are no longer falling.



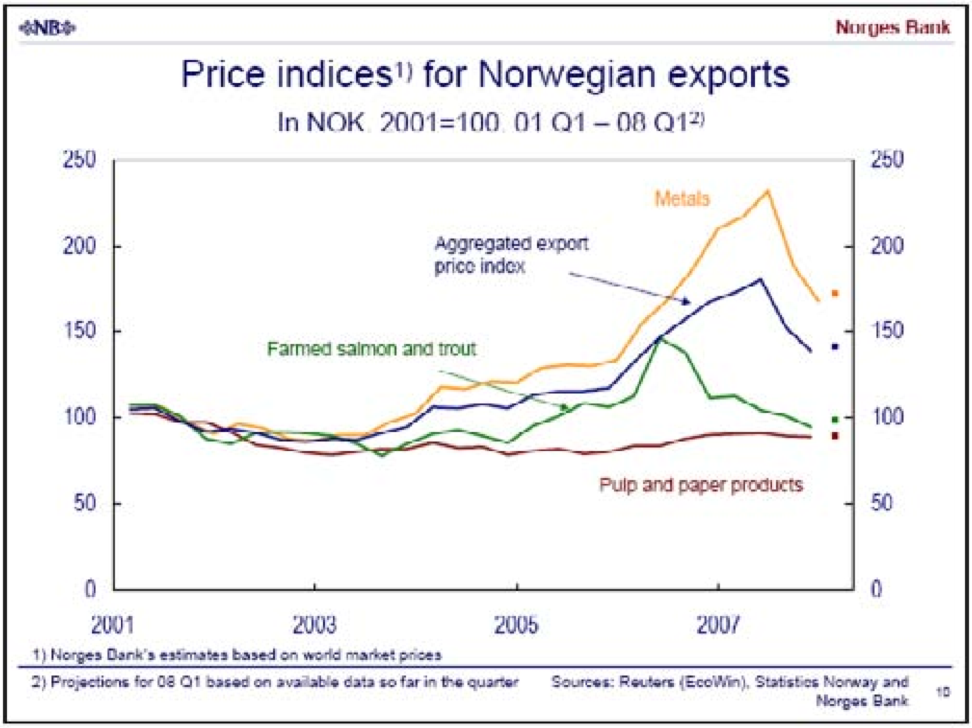
The Norwegian economy has experienced four years of strong growth. Growth has been stronger than during the economic upturn in the mid-1990s. The continuous growth period of recent years is the longest ever recorded in the quarterly national accounts, which includes figures back to 1978. Annual growth in mainland GDP in the three-year period 2004-2006 was more than 4 per cent. Preliminary national accounts figures estimate growth at 6 per cent in 2007. According to the quarterly national accounts, growth in mainland GDP remained high in the fourth quarter of 2007.

The present economic expansion differs from previous upturns in that inflation has remained low so far despite strong growth and increasing capacity utilisation. There are several reasons for this.



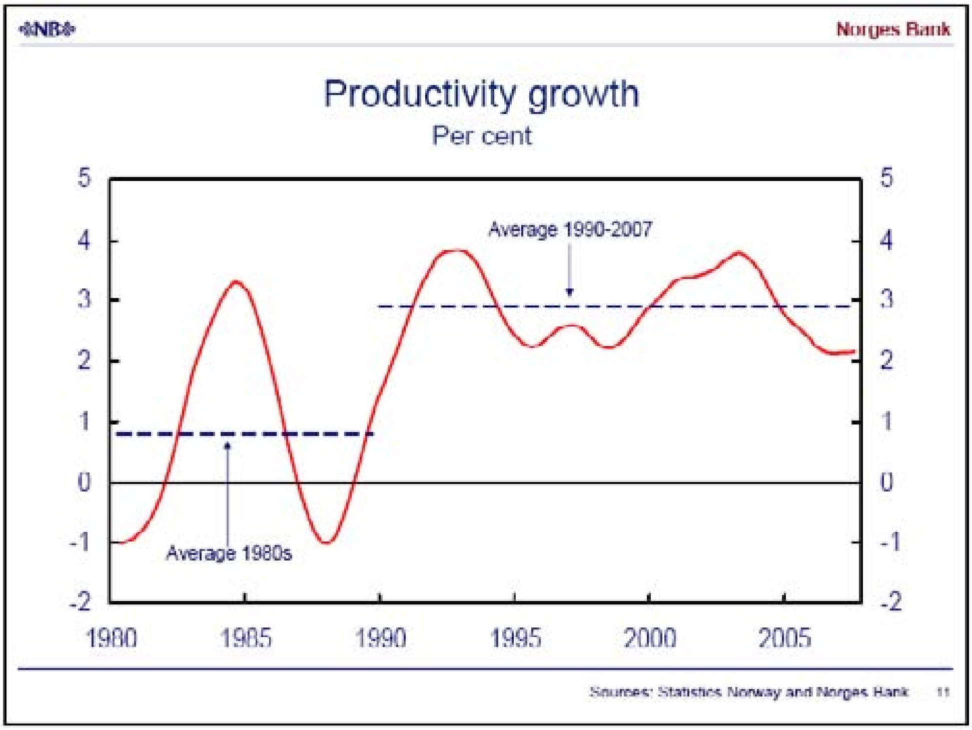
First, the economic developments have benefited from a favourable environment for Norwegian exports, in particular oil prices, which have been rising for a long period. Over the past five years, oil prices have risen by over USD 60 and have recently reached historically high levels, both in nominal and real terms.

Investment growth in the oil sector is expected to remain firm against the background of high oil prices, a high level of exploration activity and growth in investment in existing installations.

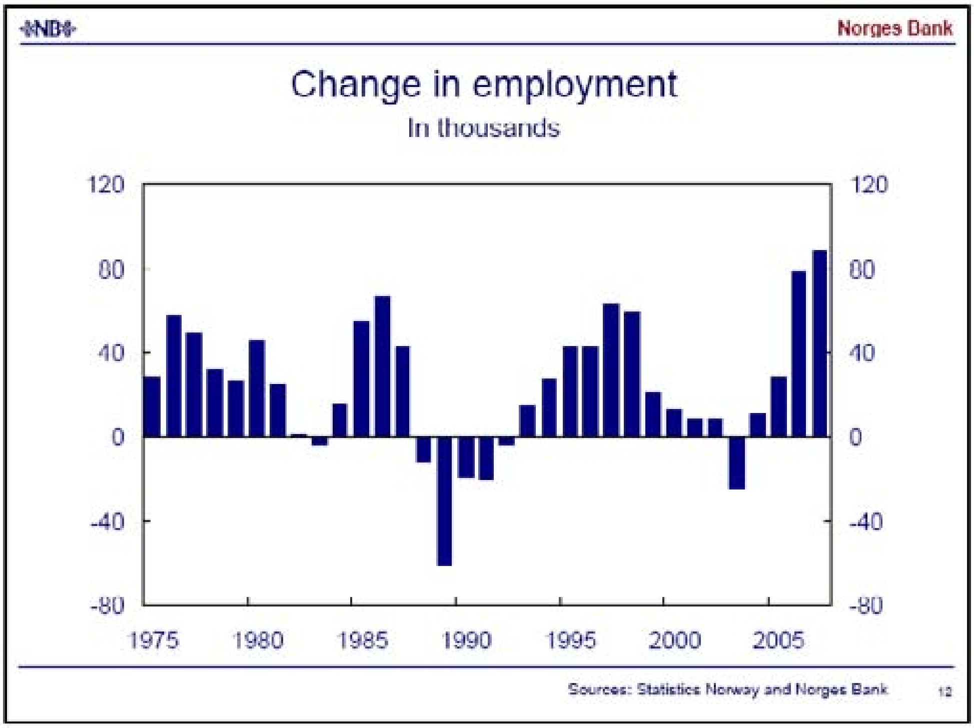


In other export markets, where prices have been rising rapidly over several years, prices for a number of important export goods, such as metals and fish, have shown wide swings. So far in the first quarter of this year, prices are on average at about the same level as in the fourth quarter of last year. At the same time, the business tendency survey showed that growth in export orders slowed towards the end of last year. Further ahead, weak developments in the US economy may further reduce exports.

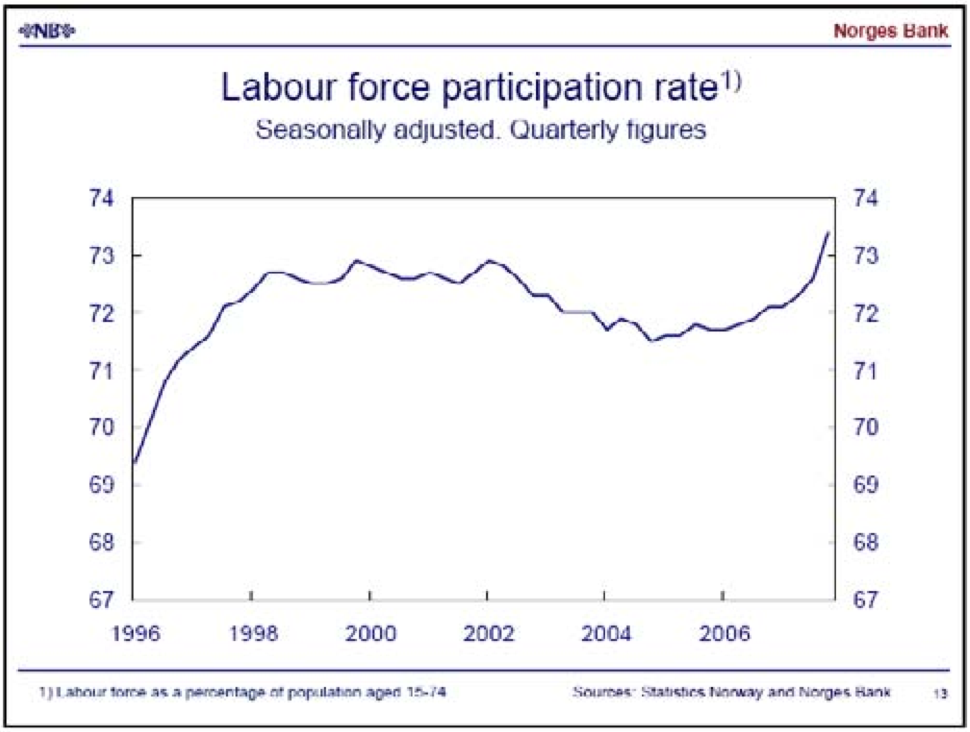
In addition to a favourable environment for Norwegian exports, Norwegian importers have gained access to new markets in central Europe and Asia which offer substantially cheaper consumer goods. As a result, Norway's terms of trade have improved appreciably over the last few years.



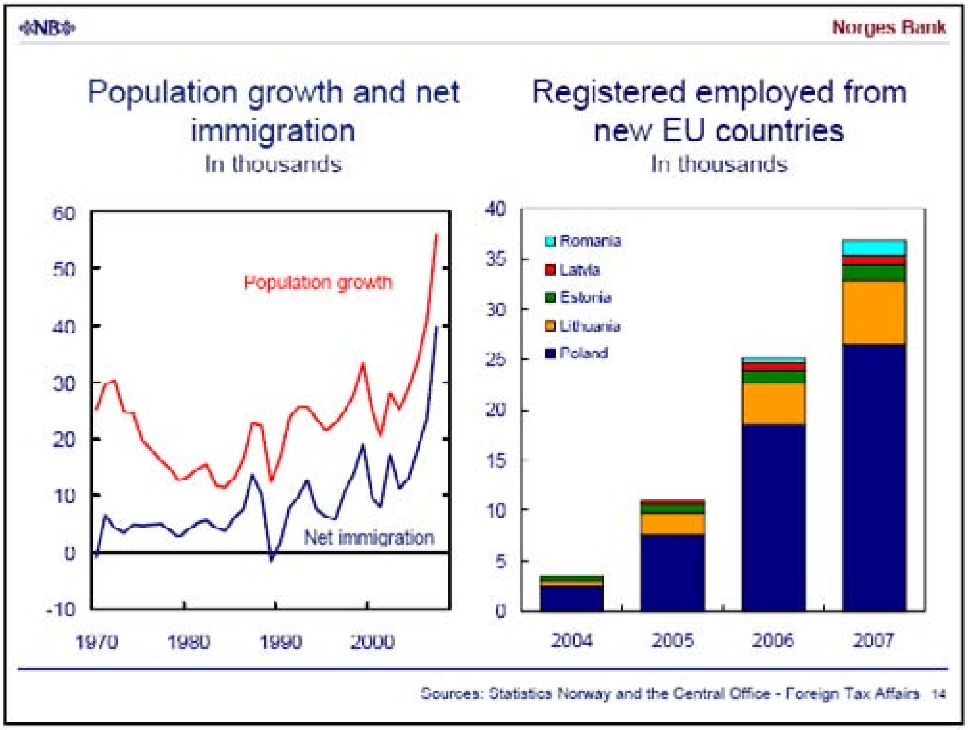
A second characteristic of this upturn is that productivity growth has been unusually high, resulting in lower production costs. The business sector has been quick to adapt and change, and to make use of new technology that is available in an international market. Banks and other service sectors, in particular, have outperformed other countries in this respect. This is probably due to the modernisation of the economy through the 1980s and 1990s, which resulted in more efficient markets.



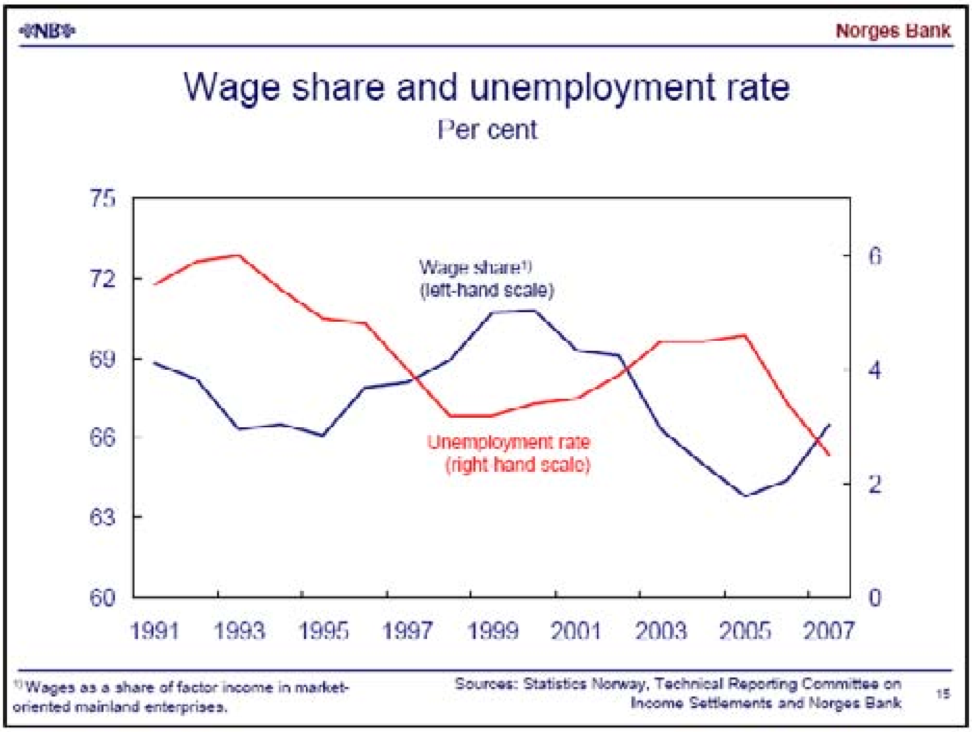
A third characteristic has been an ample supply of labour, which has boosted output growth. Over the past two years, an increase in labour force participation and high inward labour migration has provided room for continued high growth. In both 2006 and 2007, the number of employed increased by over 3 per cent. The number employed increased by 93 000 persons between 2006 and 2007, the highest increase over the past few decades.



The sharp growth in employment has partly been reflected in a decline in unemployment and an increase in the labour supply. This is due to inflows of foreign labour and increased labour participation among the existing population. Labour force participation in the age group 15-74 has never been higher. In 2007, growth in the labour force was almost as strong as employment growth. The increase in the labour supply has been particularly sharp in the youngest and oldest age groups.



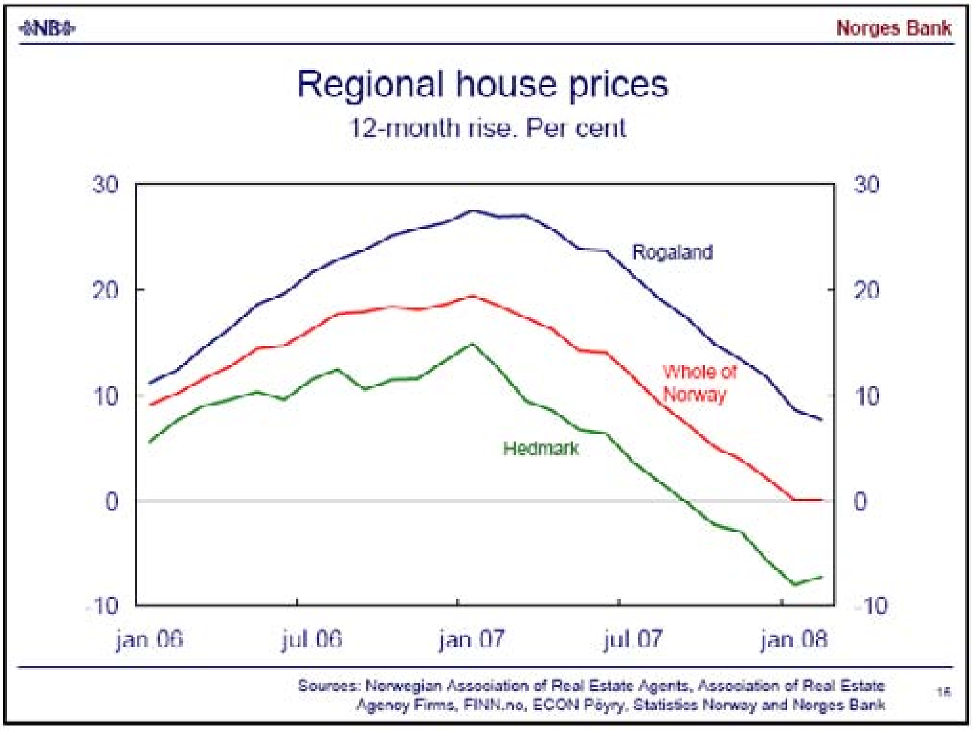
One particular feature of this upturn has been high inward labour migration, accounting for almost half of the growth in the labour force in recent years. Most work permits have been given to nationals from Poland, Germany and Lithuania. Most foreign workers from the new EU countries probably intend to remain in Norway for some time.



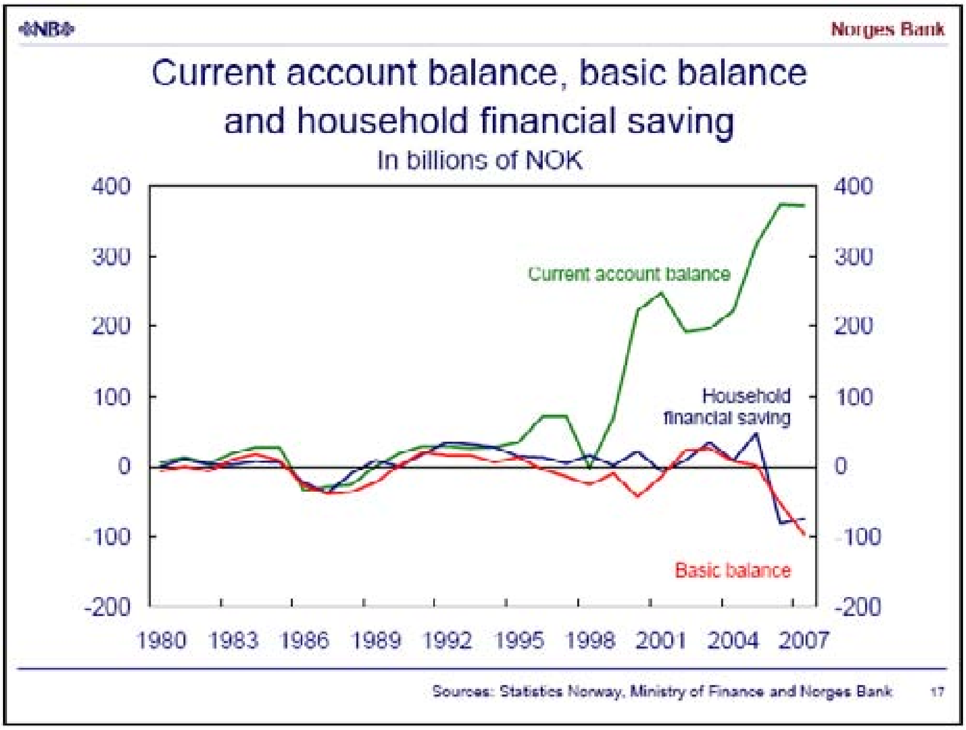
Although unemployment has fallen sharply, wage-earners' share of value added has declined since the early 1990s, but has picked up lately. Solid productivity growth and high prices for export goods and goods supplied to the petroleum sector have boosted corporate earnings and reduced the wage share over the past few years. The ample supply of labour has probably also had a dampening effect on wage growth. Increased globalisation may have provided greater opportunities for Norwegian enterprises to relocate production to other countries if labour costs become too high. This probably places some restraint on wage demands among workers in sectors where enterprises have such opportunities.

But wage-earners have also fared well. We have seen solid growth in employment, and low prices for imported goods have resulted in a subdued rise in consumer prices and a substantial increase in wage-earners' real wages.

There are now signs that productivity growth is edging down at the same time as wage growth is high.



Strong growth in real income has contributed to the long period of high housing investment and rising house prices. House price inflation peaked amid the housing market euphoria of about a year ago. The housing market is now cooling.

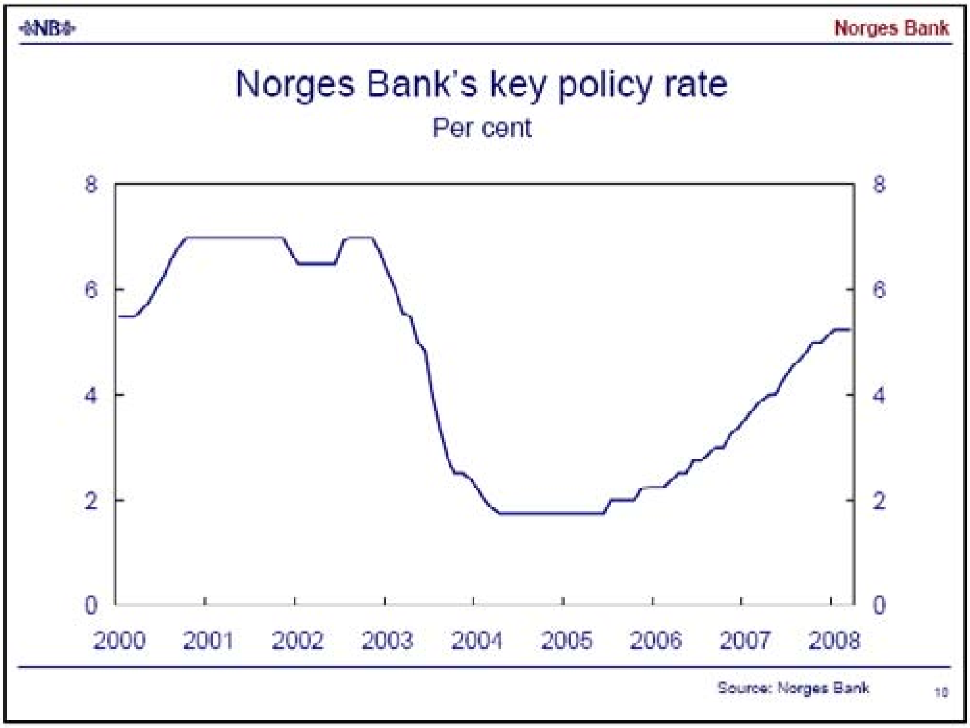


In parallel with rising house prices, households have been borrowing more and saving less. Household financial saving was negative in 2006 and 2007. At the same time, Norway has a substantial current account surplus. Most of the current account surplus is matched by government financial and oil sector surpluses – which are redeployed abroad. Adjusted for these outflows, Norway recorded a basic balance of an estimated minus NOK 150 billion in 2007, or close to 10 per cent of mainland GDP.

The corollary to the deficit on the basic balance is that Norwegian businesses, as well as Norwegian banks, borrow in foreign markets. The recent turbulence in international money markets has affected the price and supply of funding in these markets.

Monetary policy assessments

Monetary policy in Norway is oriented towards keeping inflation low and stable. The operational target is annual consumer price inflation of close to 2.5 per cent over time. Norges Bank operates a flexible inflation targeting regime. Both variability in inflation and variability in output and employment are given weight in interest-rate setting.

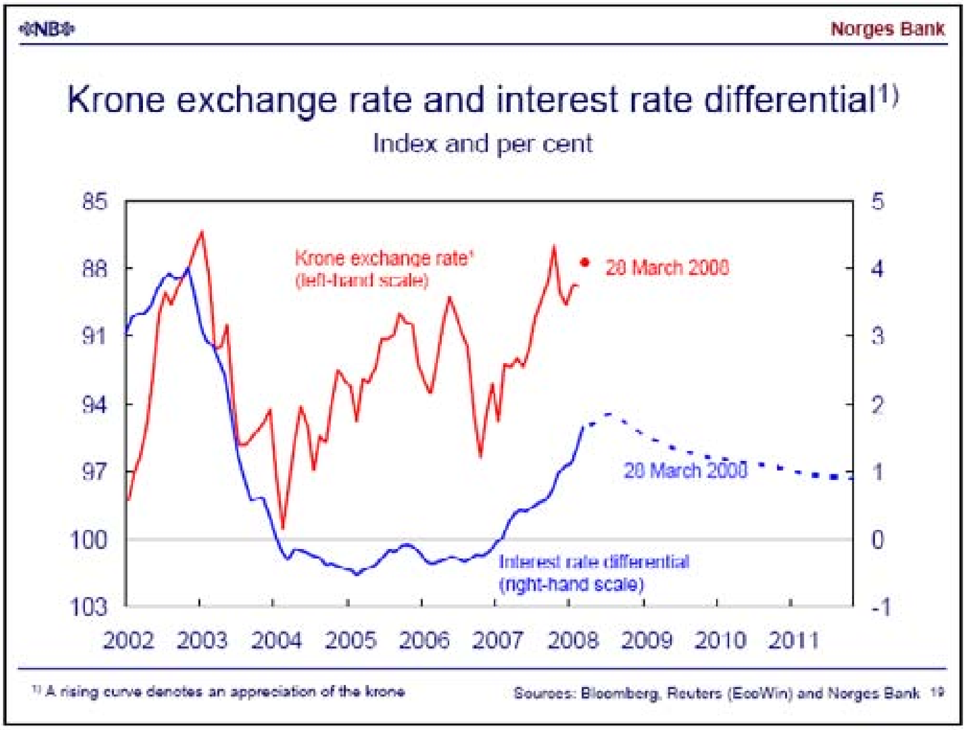


Inflation has been expected to pick up for some time. Since summer 2005, the key policy rate has gradually – and ahead of the rise in inflation – been raised by 3.5 percentage points to 5.25 per cent. This will contribute to more stable developments in inflation and in output and employment. The real interest rate has increased.

The various factors that influence interest rate prospects are pointing in different directions.

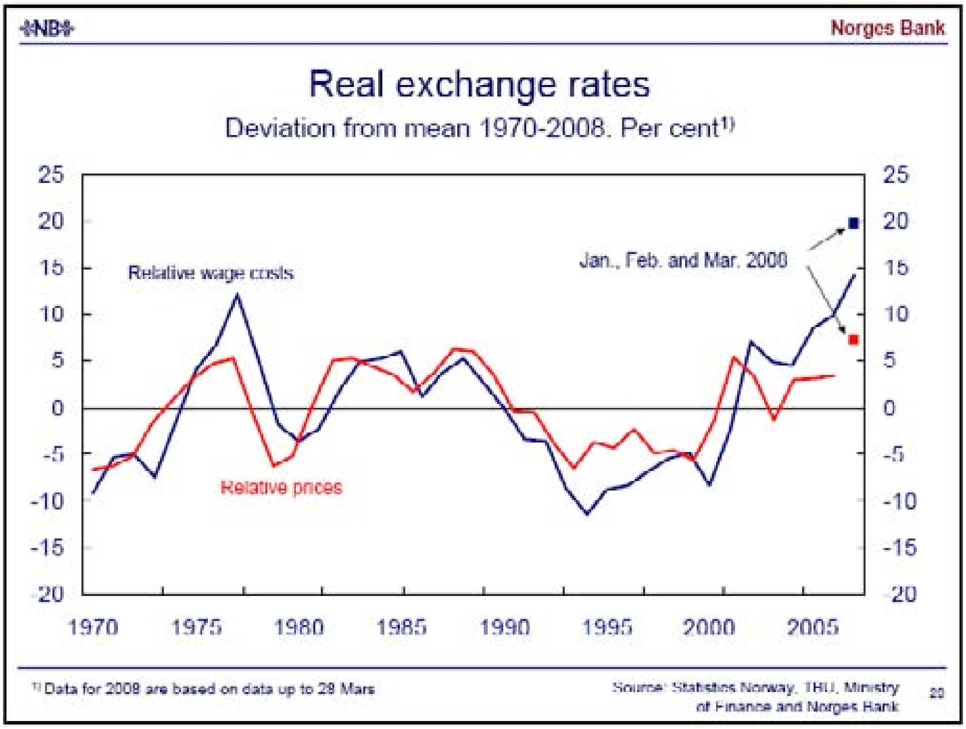
On the one hand, inflation has picked up markedly over the past few months. Growth has remained firm, capacity utilisation is high, the labour market is tight, and wage growth is picking up. In order to guard against inflation rising further and becoming too high, it may thus be appropriate to continue raising the interest rate.

On the other hand, in order to guard against an economic setback in Norway as a result of weaker external growth, it may be appropriate to leave the key policy rate unchanged for a period or lower the key rate. Weaker growth in the world economy may influence activity and profitability in the Norwegian business sectors. As a result of the financial market turbulence, we have also seen an increase in the financing costs for Norwegian banks and companies. Furthermore, the turmoil and the setback in the US may increase uncertainty among Norwegian households and businesses.



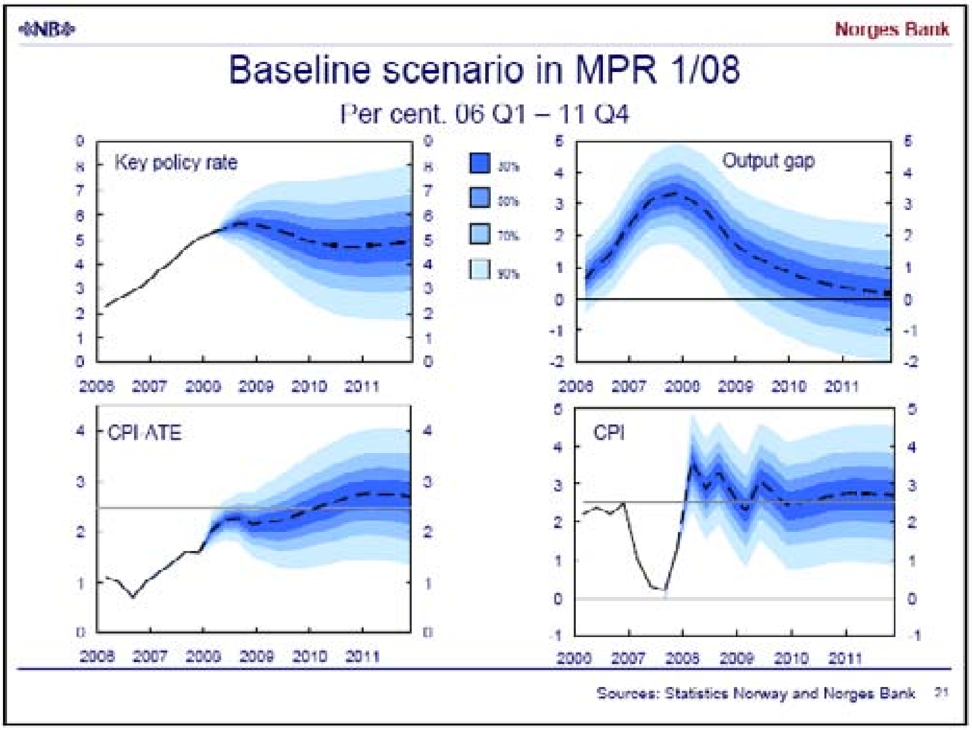
If there are prospects that the interest rate in Norway will be held considerably higher than the interest rate level among our trading partners, the krone may appreciate. But there are also opposing forces in the foreign exchange market. The basic balance deficit suggests a weaker krone. If developments in the world economy translate into lower prices for oil and other export goods, the value of the krone may also fall. If the krone depreciates, the key rate must be raised to a higher level than otherwise in order to keep inflation in check, unless slackened activity in the Norwegian economy results in lower inflation.

Over time, however, the nominal exchange rate is not the main force. The main determinant of competitiveness in Norwegian business and industry and the purchasing power of the Norwegian krone is the real exchange rate.



The real exchange rate can be measured in a number of ways, for example by consumer prices or labour costs in Norway relative to our trading partners measured in a common currency. This provides an indication of the relationship between the level of external and domestic prices, which in turn reflects developments in cost levels. In real terms, the krone has appreciated by about 10 per cent since the mid-1990s, while labour costs in a common currency have risen by close to 30 per cent more than among our trading partners. This may be partly ascribable to the cyclical expansion and the low level of household saving. But most likely the strong real krone reflects the substantial improvement in the terms of trade and productivity. In this respect, the strong krone is a sign that the Norwegian economy is faring well.

Looking ahead, the outlook and balance of risks suggest that the key policy rate may be raised further in the period to summer. The prospect of higher price and cost inflation will in the short term outweigh weaker growth in the world economy.

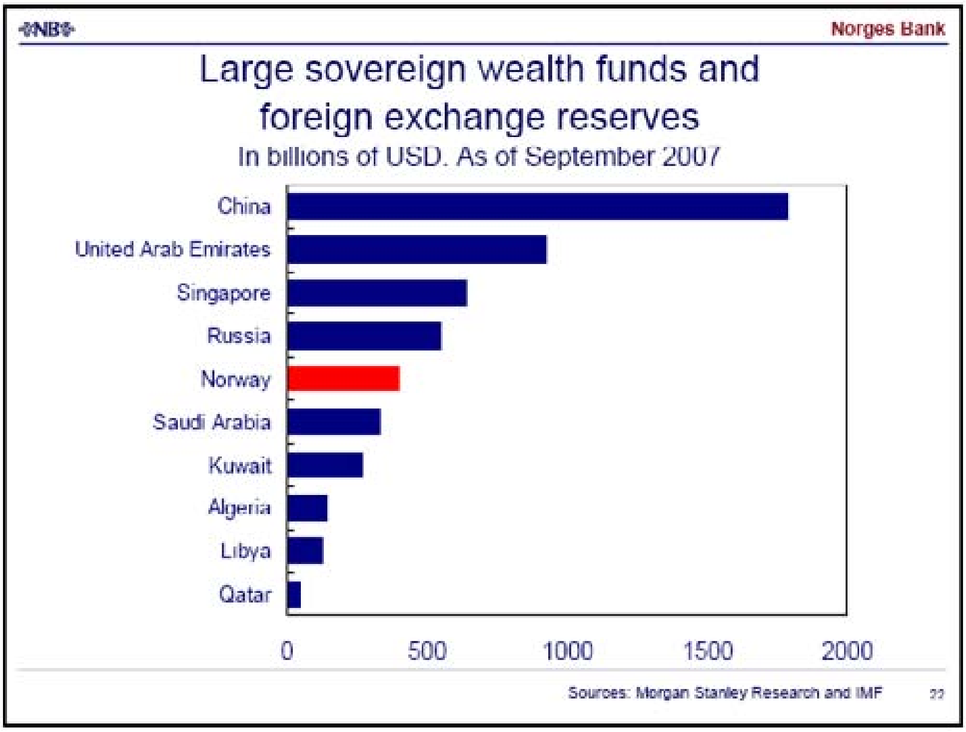


At the meeting on 13 March, Norges Bank's Executive Board held the interest rate unchanged at 5.25 per cent and presented the interest rate path shown in this chart. The Board's strategy is that the key policy rate should be in the interval 5-6 per cent in the period to end-June, unless the Norwegian economy is exposed to major shocks.

The projections are uncertain. 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, unexpectedly high cost inflation, higher import prices or a weaker krone may result in higher-than-projected inflation. On the other hand, if the global downturn has a stronger-than-expected impact on the Norwegian economy or if the krone appreciates markedly, inflation may be lower than projected. The uncertainty surrounding the interest rate ahead is illustrated by the shaded areas in the chart.

The Government Pension Fund – Global

Now, let me turn from the financial turmoil and economic developments in Norway to the Government Pension Fund – Global and the issue of sovereign wealth funds.



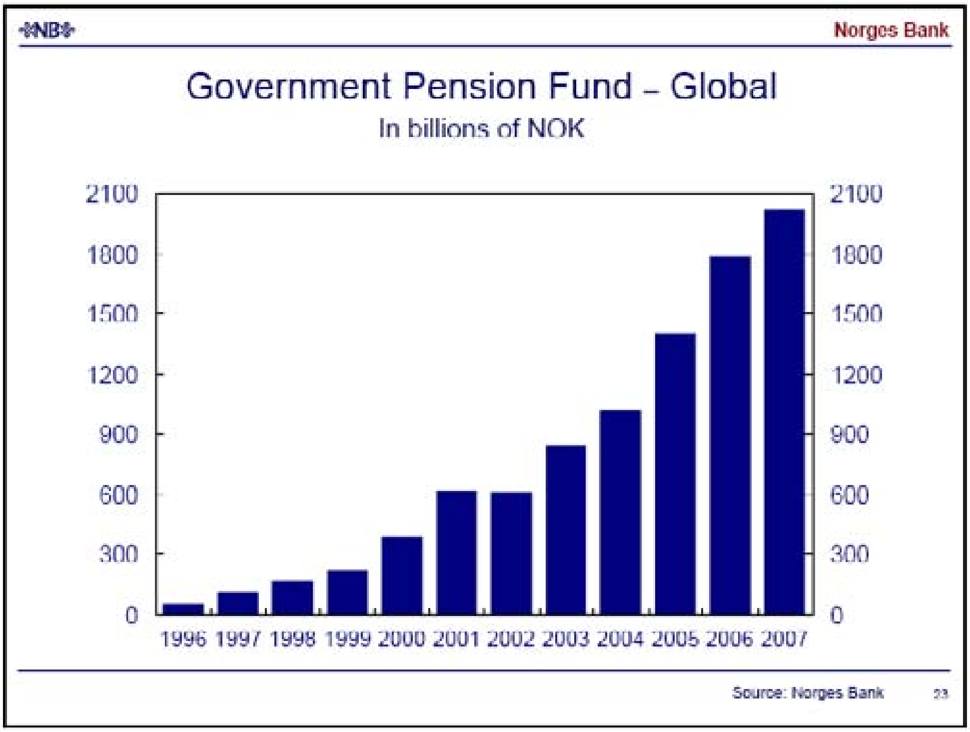
Over the past year, we have seen a growing international debate about government-owned investment vehicles; so-called sovereign wealth funds (SWFs). The increased attention reflects their rapid growth over the last decade. The debate has revealed some scepticism towards these funds, where key concerns relate to a lack of transparency and possible non-financial investment objectives.

In my view, the debate should also reflect these funds' potential to positively influence international financial markets through enhancing market liquidity and financial resource allocation. Typical features of this type of funds are long investment horizons, no leverage and no demands for the imminent withdrawal of funds, unlike the growing number of leveraged hedge funds with short time horizons. Hence, sovereign wealth funds have a high risk-bearing capacity and are resilient to short-term volatility. They may therefore act as a stabilising factor in financial markets by dampening asset price volatility and liquidity risk premiums.

Let me elaborate and exemplify this by looking at the Government Pension Fund – Global:

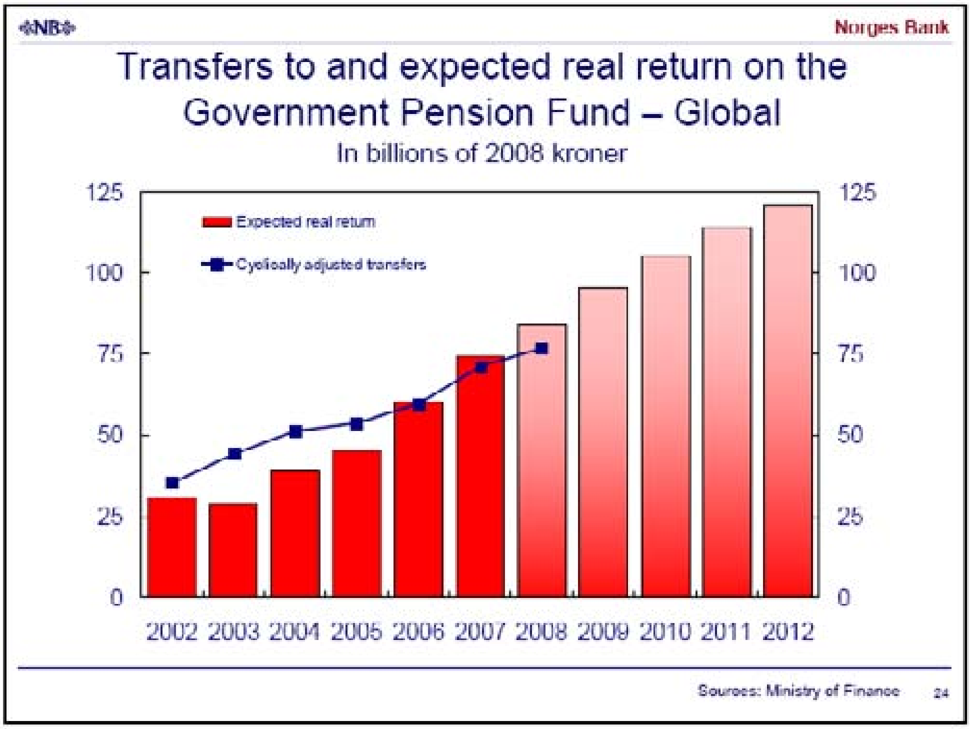
The Pension Fund is a policy tool to support long-term management of Norway's petroleum wealth and avoid the resource curse. An important objective is to shield the Norwegian economy from fluctuations in prices and extraction rates in the petroleum sector. The Fund is only invested abroad in financial markets.

The alternative to an oil fund would have been to regulate the extraction path by putting a conservative upper limit on annual extraction. By setting up the Pension Fund, we have separated the extraction of oil and gas from the actual spending of the petroleum revenues. This has probably resulted in higher production of oil and gas over the past two decades.

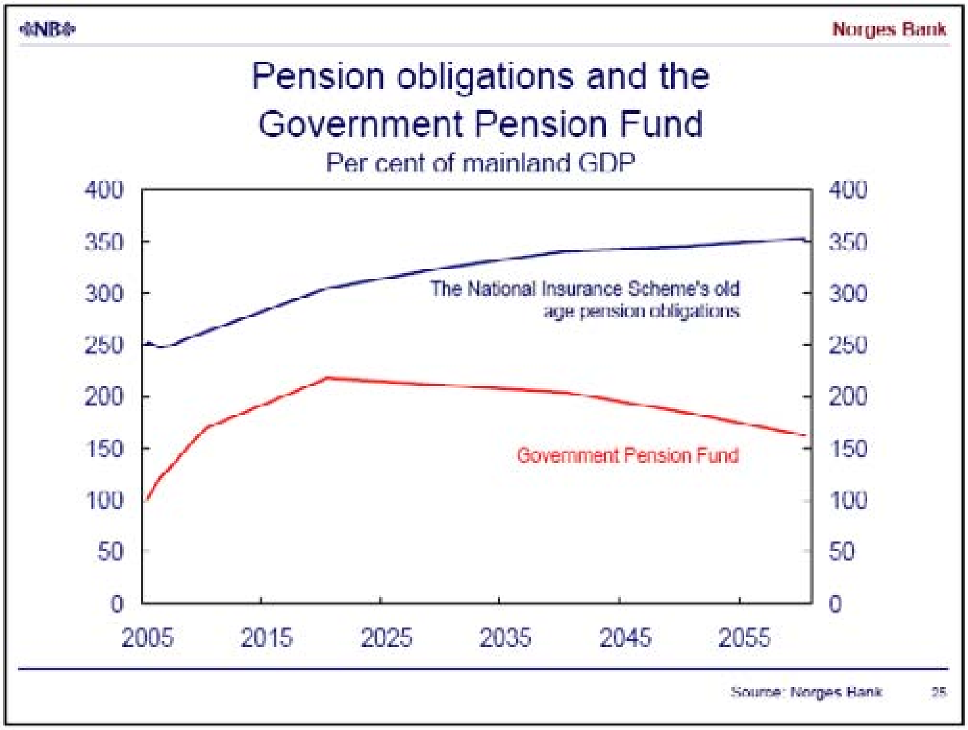


The Pension Fund was formally established in 1990, but it was not until 1996 that the first allocation – NOK 2 billion – was made to the Fund. Since then, it has grown to around NOK 2 trillion (well above USD 350 billion).

The Fund is fully integrated with the government budget, and the same priorities are imposed on spending from the Fund as on any other government spending. This means that the entire petroleum revenues, as well as the return, go into the Fund. Then, as part of the budget resolution, the Storting decides on an annual transfer from the Fund to cover the government budget deficit. This procedure effectively prohibits use of the capital in the Fund for purposes not considered sufficiently important to be prioritised in the regular budget process.



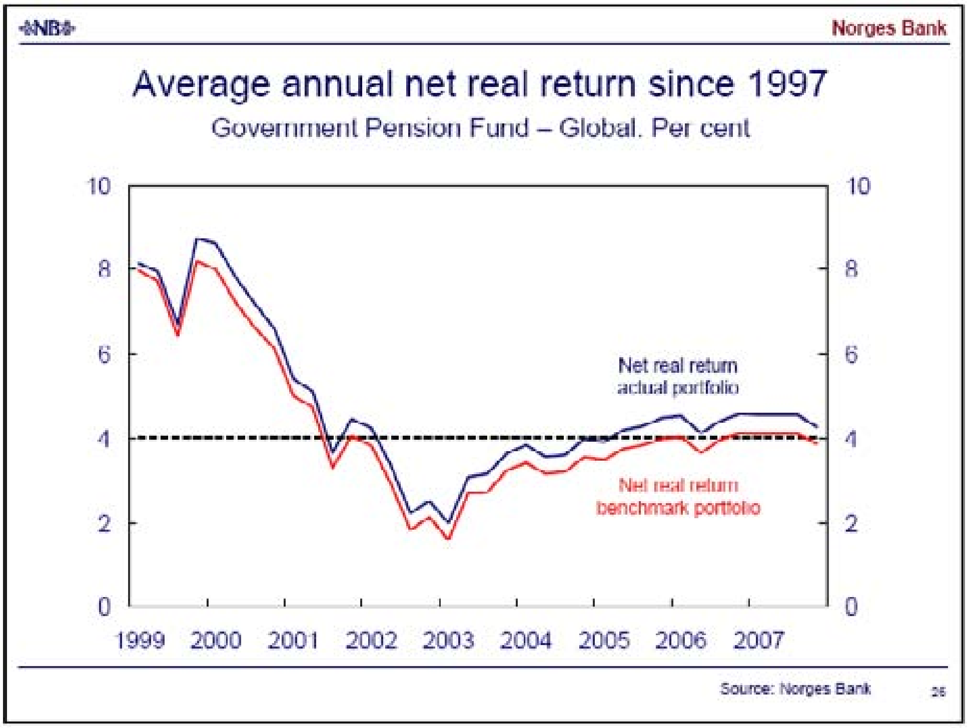
The fiscal rule states that the Government is to spend – as an annual average through the business cycle – the expected real return on the Fund, estimated at 4 per cent. This cyclically adjusted transfer is estimated at a good NOK 80 billion this year – that is around 10 per cent of public expenditure. It is estimated that the transfer will increase in the years ahead.



But even with this substantial source of income, only a share of future pension payments – which basically are financed by current income – will be matched by revenues from the Pension Fund. Estimates show that the capital in the Fund will only cover some 50-60 per cent of public pension expenditure in the future.

One key element of the Fund Management Model is accountability. The role of the political authorities as well as of Norges Bank as manager is clearly defined. Another key feature is transparency and disclosure of information.

The management of the Fund is based on two ethical commitments.



First, there is the consideration relating to future generations. The Fund must ensure high capital returns at a moderate risk, by means of professional management with effective control of operational risk.

Since 1997, the average annual net real return has been a little above the expected 4 per cent, partly due to excess return attributable to Norges Bank's management.

Second, the Fund must respect the fundamental rights of those affected by the companies in which the Fund has invested. The instruments used here are the exclusion of companies from the Fund's investment universe and the active exercise of ownership rights.

The Ministry of Finance excludes companies that produce certain types of weapons. They also exclude companies when they identify an unacceptable risk of contributing to gross corruption, severe environmental degradation, and serious violations of human rights and of fundamental ethical norms.

Norges Bank exercises its ownership rights by voting at general meetings and through direct contact with companies. Moreover, priority is given to combating child labour and we look critically at how companies influence the authorities in environmental issues.

The combination of accountability and transparency has contributed to building trust in the Pension Fund, both domestically and internationally. Domestically, a high level of confidence is vital in maintaining motivation among Norwegians for saving rather than spending the petroleum wealth. Furthermore, the transparency of the Fund is also viewed in a favourable light by those countries in which we invest, and it obviously exerts a certain disciplinary pressure on the management that improves its quality.

Thank you for your attention!