Svein Gjedrem: On business cycles, monetary policy and property markets

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the Næringseiendom conference, Bergen, 12 May 2006.

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 26 April, Inflation Report 1/06 and on previous speeches.

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

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Introduction

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. This is also 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 agents who look ahead when they make decisions about saving, investment, wages and prices.

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. 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.

Growth in the Norwegian economy has been strong since summer 2003. The reduction in Norges Bank's key rate through 2003 and into 2004 resulted in low interest rates. Low interest rates have contributed to a relatively sharp rise in household demand throughout this upturn. At the same time, solid growth in other countries has generated increased demand for many Norwegian export goods, resulting in high prices. Petroleum sector fixed investment has increased strongly, resulting in growing demand for goods and services supplied by mainland enterprises. Mainland fixed investment has also picked up.

Commercial property markets

After several years of fairly low activity, the number of commercial building starts is now increasing nationwide, including in Hordaland, where growth in this industry is solid.

Through last year and so far this year, building activity has been particularly high in the retail trade sector. Commercial building starts have more than tripled since the trough in 2003.

These developments are reflected in the lending figures. Through 2004 and 2005, banks' and mortgage companies' lending to enterprises in property management and services, and the retail trade and hotel and restaurant sectors increased markedly. In the first quarter of this year, total lending to these sectors was NOK 440 billion, an increase of close to NOK 73 billion compared with the same quarter last year.

The value of shop premises has risen more than the value of office premises since the mid-1990s, and more in line with the rise in the housing market.

Developments in the value of office premises in Norway have tracked developments in a number of other European countries. Office premises have a dominant role as investment vehicles and are therefore most important for the commercial property market as a whole.

Investment in new commercial properties partly depends on developments in rental rates and the number of vacant premises.

Developments in rental rates for office premises in Norwegian cities over the past twenty years appear to have been fairly uniform, with very high rates at the end of the 1980s, followed by a marked negative correction towards the mid-1990s. Rental rates then rose considerably up to the end of the century, followed by another downward correction. Stavanger seems to have experienced a relatively even rise in real terms throughout the period. Rental rates in Trondheim and Bergen seem to have had a less pronounced peak at the end of the century than Oslo, while rental rates in Tromsø have been relatively stable since 1992.

Last year rental prices for office premises began to pick up in several Norwegian cities. There is considerable variation within the various quality and location segments. The prestigious segment in central business areas shows the highest rise in prices, while rental prices in some less attractive areas have remained virtually unchanged.

During the cyclical peak between 1997 and 2001, only 4 per cent of the office premises in Oslo were vacant. More moderate economic growth in 2002 and 2003 contributed to a fairly sharp rise in the vacancy rate. Over the past two years, the rate has fallen again. At 8 per cent, the vacancy rate is still relatively high, although in some central areas, it has fallen to below 4 per cent. The share of vacant office premises in Bergen has been lower than in Oslo for the past three years.

The value of property has increased, both in Norway and in other countries, even though the rise in rental rates has been moderate and the vacancy rate has been high. Investors have been willing to pay more than previously for a krone, a dollar or a euro in future net rental income. The direct return, i.e. annual rental income minus operating costs as a share of the price paid for the property, for office premises in Oslo has fallen to a historically low level. This is probably related to developments in long-term interest rates. An investor will expect a higher return on property, and property as an asset class is probably midway between equities and bonds in terms of both risk and return. Since nominal interest rates are low, many investors prefer to move their low-risk investments from the bond market to alternative vehicles such as property.

Developments in the real value of office premises and our estimates of capacity utilisation in the Norwegian economy seem to co-vary in the period 1980-2005. The effect on the value of office premises prior to the banking crisis was much greater than the effect of a similar level of capacity utilisation in the years 1998-2000. This supports the interpretation of the first price peak as a property price bubble.

The value of office property increased in 2005, from a historically low level. In relation to historical levels, the rise in the value of commercial property seems to be moderate, compared with the rise in capacity utilisation. One possible reason for this may be that employment growth was for a long period relatively low in this upturn compared with the upturns in the 1980s and 1990s. This has now changed. In addition, signals from market participants indicate that the rise in value for 2005 as a whole will be sharper than the chart estimate, which was calculated as of July 2005.

Developments in real house prices also tracked developments in capacity utilisation from 1985 to 1998. In the period since then, however, house prices have increased further at a steady pace, even when business cycles have fluctuated. This sharp rise, combined with similarly strong growth in household debt, may 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 deregulation. 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 making a contribution.

Sales in the commercial property market reached a very high level in 2005. House sales totalled NOK 44 billion, twice the total for the previous year. Syndication companies and property funds account for almost half of total sales.

In Sweden, the share of foreign investors has been relatively high, and rising, for several years. In comparison, foreign ownership in the Norwegian property market is modest, but probably increasing. For example, the German property fund DIFA purchased parts of the Norwegian School of Management's college premises in Nydalen in Oslo, and the Scottish Kenmore Property Group has purchased commercial property in Norway for more than NOK 1.4 billion.

In a comparison of property markets conducted in 2004, Norway was classified as "highly transparent".[1] Increased liquidity and transparency promote foreign interest in Norwegian property.

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[1] Jones Lang LaSalle, Global Real Estate Transparency Index 2004.

The economic situation

The mainland economy expanded by 3.7 per cent in 2005. Growth in private services, construction and electricity production was strong. So far, a substantial share of output growth has been attributable to a sharp rise in person-hours worked. The fall in sickness absence in 2004 provided an additional supply of labour to enterprises, but sickness absence increased through 2005.

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.

The labour market continues to tighten. It is likely that continued strong growth in output and employment will result in a higher rise in prices and costs, but it may take time. According to Statistics Norway's Labour Force Survey (LFS), employment growth picked up markedly towards the end of 2005 and into 2006. LFS unemployment fell again in January. The number of registered unemployed fell somewhat in April and now stands at 2.8 per cent. Measured in per cent of the labour force, seasonally adjusted LFS unemployment was 3.9 per cent.

The labour supply is also being influenced by an increase in inward labour migration from the new EU accession countries. The Central Office – Foreign Tax Affairs recorded an increase of about 7400 employees from the new EU accession countries from 2004 to 2005. This figure covers employees in both Norwegian and foreign enterprises. The size of the actual supply of labour behind these figures is uncertain, because there is no information about the duration of such employment relationships. On balance, however, there have been signs that the use of foreign labour has contributed to dampening pressures on real economic resources through the upturn. The effect has probably been most marked in the construction industry, as evidenced in particular by the fact that wage growth remained moderate last year, despite the very high level of activity. The figures for the first quarter of this year indicate that inward labour migration is still rising.

There is competition for the best labour in the EU countries. Many people have travelled to the UK and Ireland in particular, and the barriers to inward labour migration may be greater in the Norwegian labour market than in the British and Irish labour markets. Activity is edging up in the central European countries. Therefore, there is uncertainty about how large the supply of labour will be from these countries in the future.

There is also considerable inward labour migration from other Nordic countries, but measured in terms of number of persons, the supply of labour from these countries has not changed substantially in recent years. Swedish nationals have comprised the bulk of the supply of labour from the Nordic countries. 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.

The supply of labour is also affected by developments in persons on disability benefit and sickness absence. The trend in sickness absence has reversed, and is now rising, and the number of persons on disability benefit continues to show a steady increase.

Consumer price inflation has edged up, but is still very low even 2½ years after the cyclical change. The year-on-year rise in the consumer price index (CPI) was 2.7 per cent in April. Price impulses from consumer goods imported to Norway have been negative virtually every year since the mid-1990s. This is due to international trade liberalisation and a shift towards imports from low-cost countries.

The rise in prices for domestically produced goods and services slowed somewhat towards the end of 2005 and into 2006. The 12-month rise in prices for these products is estimated at 1.6 per cent in April, adjusted for the effects of lower maximum day-care rates. However, several factors point towards rising inflation. Capacity utilisation in the Norwegian economy is increasing, and tighter labour market conditions may result in higher wage growth in the coming years. The rise in oil prices is resulting in higher input costs for producers.

As a rule, monetary policy shall not take account of the direct effects on consumer prices resulting from changes in the interest rate level, taxes, excise duties and extraordinary, temporary disturbances. However, there is no certain method for distinguishing extraordinary, temporary disturbances from more long-lasting price changes. The inflation measure CPI-ATE excludes the effects of changes in taxes and energy prices. Norges Bank has given weight to this indicator of underlying inflationary pressures in the economy, but also keeps an eye on other indicators. The 12-month rise in the CPI-ATE adjusted for the effects of lower maximum day-care rates is estimated at 1.0 per cent in April.

However, the CPI-ATE not only strips out temporary effects of changes in tax changes and fluctuations in energy prices, but also trend changes in these variables. Thus, this indicator is not a perfect measure of underlying inflation. In the last 10-20 years, where energy prices have risen at a faster pace than other consumer prices and the tax level has increased somewhat, the CPI-ATE has tended to underestimate underlying inflation. This is illustrated in the chart, which shows the difference between the year-on-year rise in the CPI and the CPI-ATE over a moving 10-year average. Since 1997, the difference has been about 0.35 percentage point. However, even when taking into account trend increases in energy prices, inflation is still moderate. The indicators that provide the best expression of underlying inflationary pressures in the economy may vary over time.

Driving forces ahead

Oil prices are of importance for the activity level in the Norwegian economy and government revenues. In recent years, oil prices have risen sharply. High demand for oil, limited idle production capacity and uncertain production levels in many oil-producing countries have contributed to this. Oil prices have risen to over USD 70 per barrel, partly as a result of the uncertain political situation in a number of producer countries. Futures prices for Brent Blend are now also above USD 70 per barrel until autumn 2008. Futures prices indicate that oil prices will remain around this level several years ahead. This is higher than the level assumed in the previous Inflation Report. Statoil and Hydro gas prices have also increased sharply in recent months.

Petroleum production is expected to increase gradually in the period to 2011, and decline thereafter. Developments in the gas market will become increasingly important. In the next 10 years, gas production could rise to at least the same level as oil production, measured by energy content.

High oil prices 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. A number of companies have revised up the long-term oil prices that are used as a basis for investment decisions, but they are still moderate compared with futures prices.

Further out in the projection period, developments in petroleum-related investment become highly uncertain. It is assumed that overall activity will decline somewhat when the Snøhvit and Ormen Lange projects are completed, but high oil prices are expected to contribute to maintaining investment at a relatively high level throughout the projection period.

The Government Pension Fund – Global, previously called the Government Petroleum Fund, will increase substantially in the years ahead. The fiscal rule entails a gradual phasing-in of petroleum revenues into the economy, approximately in pace with the expected real return on the Fund, which is estimated at 4 per cent. On the basis of our assumption in the March Inflation Report for developments in oil prices (oil futures prices), the fiscal rule allows for an increase in petroleum revenue spending of more than NOK 30 billion from 2006 to 2009.

If the Norwegian economy continues to exhibit solid growth, it will nevertheless be in line with the fiscal guidelines specifying that petroleum revenue spending is lower than the expected real return for a few years. Our projections are based on the assumption 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.

High growth in the global economy has pushed up prices for non-oil commodities as well. Over the past year, copper prices have more than doubled and aluminium prices have risen by more than 60 per cent. Futures prices have also risen markedly, indicating expectations of a permanent upward revision of metals prices similar to the revision of oil prices.

Rising commodity prices and buoyant activity in markets that are important for Norway have fuelled growth in the Norwegian economy, even though growth has been low in some of Norway’s most important export markets.

Overall, prices for our imported goods are falling in relation to prices for goods we export. Norway’s terms of trade are improving. 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 domestic economy is partly insulated thanks to the oil fund mechanism. The situation in Norway differs from that of its Nordic neighbour 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.

Growth among our trading partners remains solid. High commodity prices are exerting upward pressure on consumer price inflation in a number of countries, although underlying inflation remains low. Economic growth in the US probably picked up again in the first quarter. In Japan, growth appears to be solid. In the euro area, confidence indicators point to optimism in the business sector. There is a broad-based expansion in the Swedish economy, while some indicators in the UK have shown weak developments.

The central banks in Canada and Switzerland have raised their key rates by 0.25 percentage point since mid-March, while the Federal Reserve has raised its key rate by 0.5 percentage point. Market expectations concerning key rates in other countries have risen slightly. For the coming year, market pricing indicates that key rates will be increased in the euro area, the UK, Sweden, Switzerland, the US, Canada, Japan and Australia.

In Norway, the key rate was last raised by 0.25 percentage point to 2.5 per cent at the monetary policy meeting on 16 March this year. Financial markets still expect a gradual increase in the sight deposit rate ahead. In line with developments in global markets, the rise in Norwegian long-term interest rates has gathered pace. Markets have factored in that the key rate will be lower in Norway than in the US and the UK at the end of 2009, but higher than in the euro area and Sweden.

Monetary policy assessments

Since last summer, interest-rate setting has been oriented towards a gradual increase in the interest rate – in small, not too frequent steps – towards a more normal level. According to the assessment in the March Inflation Report, higher growth in the economy could, in isolation, warrant a faster rise in the key 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 to the target of 2.5 per cent and anchoring inflation expectations suggested in isolation that further interest rate increases should be delayed until there are clearer signs of a further rise in inflation.

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 economy. The shift in trade towards low-cost countries has led to lower prices and higher real income. In addition, the changes in the world economy have provided Norway with higher income because our terms of trade have improved. Increased competition has curbed the rise in prices for a number of domestically produced goods and services.

When inflation deviates substantially from the target for a period, the interest rate will be set with a view to gradually returning it to the target, so that we avoid substantial variations in output and employment. Through the 1990s, inflation generally remained in the interval 1½ – 3½ per cent. Inflation has varied slightly more in the past few years. In a period of increasing cross-border labour flows, substantial technological advances, changes in competitive conditions and new trading patterns, we may, with our very open economy, have to accept a somewhat greater variation in inflation and deviations from the target, as we have witnessed over the past two to three years.

An overall assessment implies that the interest rate in the baseline scenario gradually increases to a more normal level. The projections are based on the assumption that interest rates in Norway and abroad will rise somewhat faster than may be implied by today's forward rates. Since the previous Inflation Report, the upward movement in Norwegian and international long-term interest rates has become more pronounced. Exchange rate movements are difficult to project. In Inflation Report 1/06, the path for the interest rate in Norway and abroad was assessed to be consistent with an approximately unchanged krone exchange rate.

The high rate of economic growth implies that price and cost inflation will edge up after a period. Inflation measured by the CPI-ATE is projected to increase from today's level of around 1¼ per cent, up to almost 2 per cent at the end of 2007. There are prospects that inflation will increase further and be close to the target of 2.5 per cent three years ahead. With a gradual reduction in unemployment, Norges Bank expects wage growth to edge up. At the same time, it will probably be easier for enterprises to pass on cost increases to prices in pace with the rise in demand and capacity utilisation.

Capacity utilisation is now projected to be somewhat higher than its normal level. Mainland GDP is still growing strongly in 2006. Capacity utilisation in the economy is expected to rise over the next two years. Even though a gradual increase in the interest rate will result in somewhat weaker growth impulses after a period, monetary policy will still be expansionary. A further interest rate increase will stabilise growth in output and employment. Capacity utilisation may in time be brought down somewhat and stabilise. This will curb the rise in inflation, so that it stabilises close to target.

Developments in inflation and capacity utilisation seem to provide a reasonable balance between the various objectives of monetary policy. The interest rate is sufficiently low for inflation to approach the target of 2.5 per cent while avoiding a capacity utilisation level that is too high.

Projections are uncertain. We have illustrated this uncertainty in the projections for the interest rate, the krone exchange rate, inflation and capacity utilisation using fan charts. The width of the fan is based on historical disturbances. However, there is no certainty that future disturbances will be of the same character or scale. The wider the fans, the more uncertain the forecasts are. In other words, uncertainty with regard to the interest rate reflects the monetary policy response to unexpected disturbances in inflation, output and the exchange rate.

When the interest rate, as forecast in the baseline scenario, is raised to a more normal level, Norges Bank will be able to assess the effects of interest rate changes and other new information about economic developments. According to our projections, inflation will be close to target three years ahead. We are uncertain as to the functioning of the economy and how long it will take for the resource shortages observed in some sectors of the Norwegian economy to translate into higher inflationary pressures. This may warrant small steps in interest-rate setting.

Employment is now rising more rapidly than expected. Corporate earnings are rising sharply, with higher growth in corporate demand for credit. The sharp rise in household debt is continuing. House price inflation remains high. This is to some extent due to structural adjustments, but gives cause for some concern nevertheless. Wide fluctuations in asset prices may be a potential source of instability in demand and output in the somewhat longer run. Prices for oil and several other commodities have picked up further. At the same time, the underlying rise in consumer prices remains low. So far, a tighter labour market does not seem to have resulted in higher-than-expected pay increases, but there is a risk that wage growth may subsequently rise faster than projected. The krone is stronger than assumed. Overall, there are not sufficient grounds for changing the outlook for inflation and output or the risk assessment.

The press release following the monetary policy meeting on 26 April states that in line with the forecast in the March Inflation Report, there are prospects of another interest rate increase in the second quarter – at the monetary policy meeting in May or June – and a further increase thereafter.

Thank you for your attention.