Svein Gjedrem: The economic outlook in Norway

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, Oslo, 22 March 2007.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 15 March, Monetary Policy Report 1/07 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 Norges Bank's website.

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Excellencies, Ladies and Gentlemen,

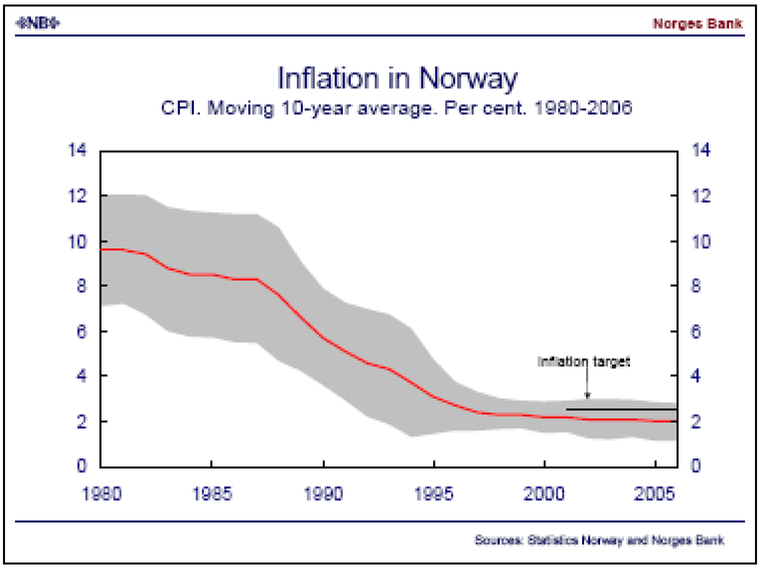
First of all, I would like to welcome you to Norges Bank.

This event gives me an opportunity to discuss developments in the Norwegian economy and to present Norges Bank's view of the economic outlook for Norway. It also gives us an occasion to discuss other issues of mutual interest in an informal setting.

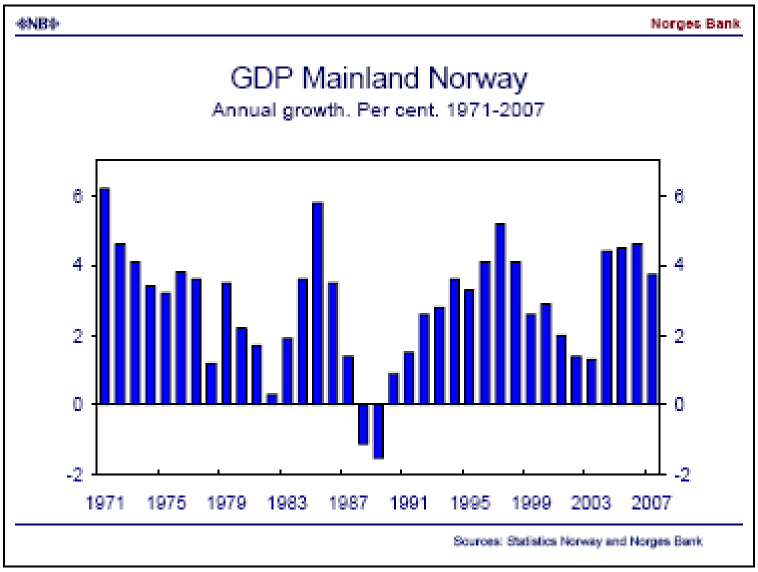
The Norwegian economy has been affected by several positive supply-side shocks over the last decade. I am thinking in terms of the effects from increased global trade and freer flow of labour across national borders. I want to discuss how these shocks have had an impact on economic growth and inflation. These shocks have also affected prices in the Norwegian housing market, and they have had a strong impact on the income from the petroleum sector and thereby the transfer of funds to the Norwegian petroleum fund.

Economic developments

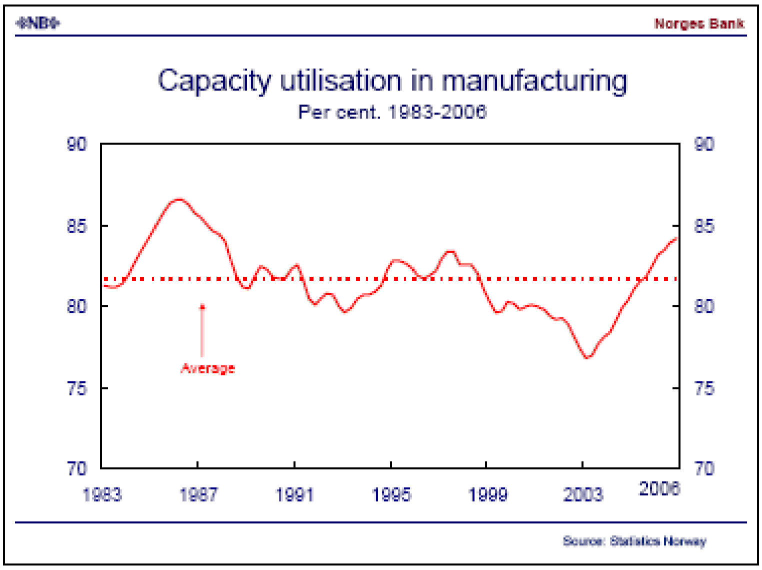
Monetary policy in Norway is oriented towards low and stable inflation, with annual consumer price inflation of close to 2.5 per cent over time. Norges Bank operates a flexible inflation targeting regime. Both variability in inflation and variability in output and employment are given weight in interest-rate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



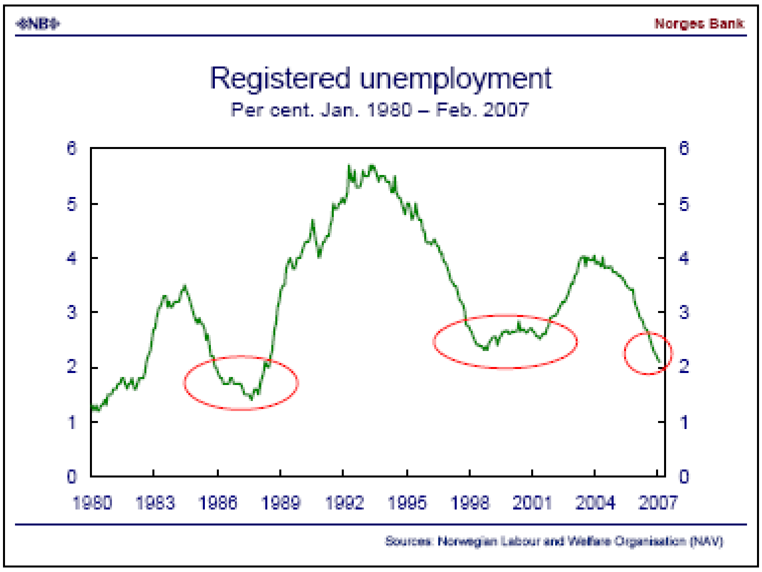
Inflation decelerated markedly from the end of the 1980s to the mid-1990s and has since been low and stable with considerably lower variability than earlier. Over the past 5-10 years, inflation has been fairly close to, but somewhat lower than the target.



The Norwegian economy is now growing strongly, following a pronounced upswing since summer 2003. 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. Average real growth rates for the past three years were well above 4 per cent.



Since the economic recovery started, it has gradually broadened. Capacity utilisation is now high in most industries, and there are reports of limited capacity in most regions. The number of unfilled vacancies is rising, and labour shortages are reported in almost every occupational category. There are shortages of drivers, pre-school teachers, supervisors, engineers, carpenters, architects, auditors, accountants, IT personnel and health workers. It has probably not been since the 1970s that we find such widespread reports of purely physical production constraints, for example now in the form of shortages of rigs and other equipment in the petroleum industry or shortages of plank, concrete and insulation in the construction industry.



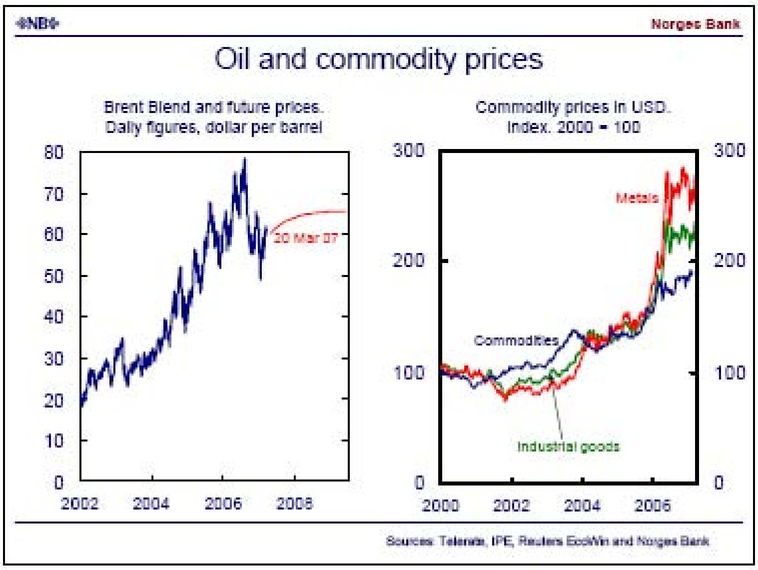
Unemployment has fallen markedly over the past year. The pace of decline and the level of unemployment are reminiscent of two earlier cyclical peaks, one in the mid-1980s and the one that began at the end of the 1990s and continued into the present decade. Both booms culminated in sharply accelerating cost and wage inflation.

Supply-side shocks to the Norwegian economy

The combination of strong growth, high capacity utilisation and low inflation is a reflection of favourable global developments and a number of positive supply-side shocks to the Norwegian economy.

The global expansion of recent years has resulted in strong growth in Norwegian export industries. Employment has increased and unemployment has declined. The favourable labour market has boosted household optimism and supported private consumption. Strong demand growth and solid profitability have also paved the way for growth in business fixed investment in Norway.

So far, the weakening of the US housing market has not had pronounced spill over effects. Growth in China and India is strong and the euro area is experiencing a broad-based upturn. Global growth is probably less dependent on demand for goods and services in the US than was the case earlier.

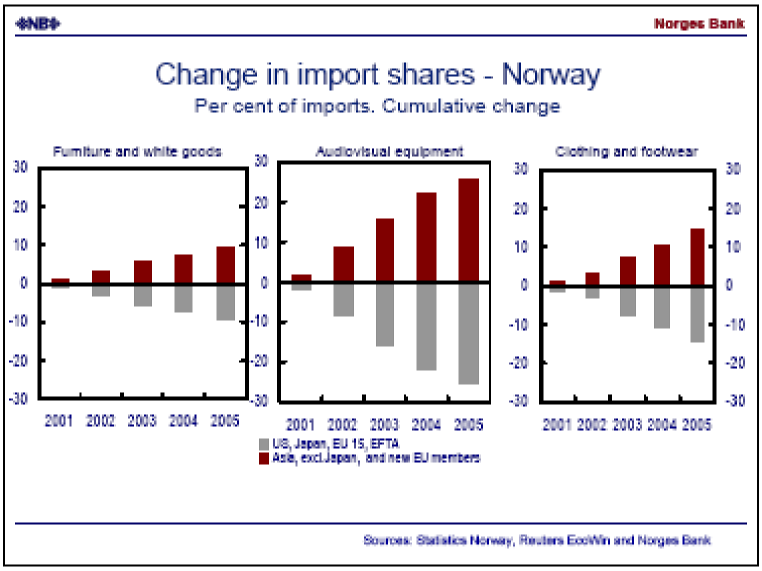


The global expansion has also resulted in high prices for many Norwegian export goods. The increase in oil prices over the past 4-5 years has been very important. High oil prices over a longer period have boosted oil investments and there are prospects that the high investment level will be sustained in the coming years.

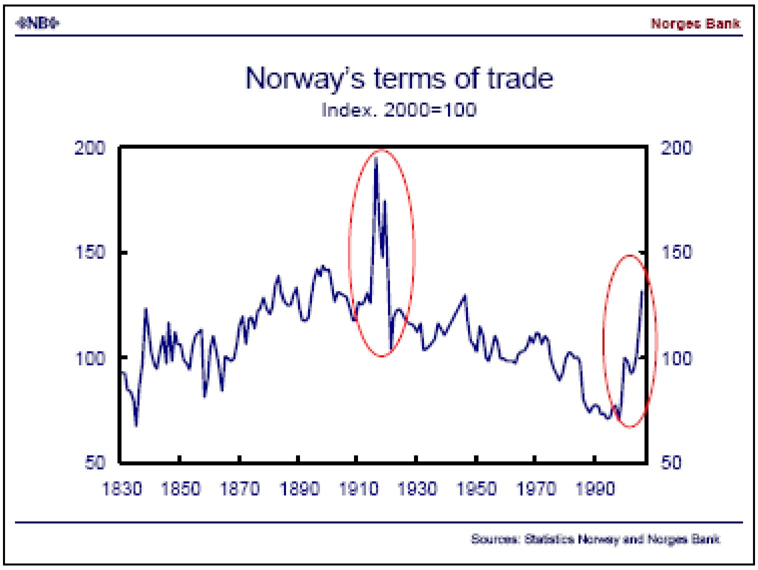
Oil prices peaked around USD 75 per barrel in summer 2006. Later in autumn, prices fell. Current futures prices indicate that market participants believe prices will remain above USD 60 per barrel in the coming years.

A fall in prices in a number of commodity markets at the beginning of 2007 raised the question of whether the pronounced price rise of recent years was being reversed. The experience of previous commodity price cycles indicates that rising prices gradually lead to increased supply and reduced demand. This in turn leads to a fall in prices.

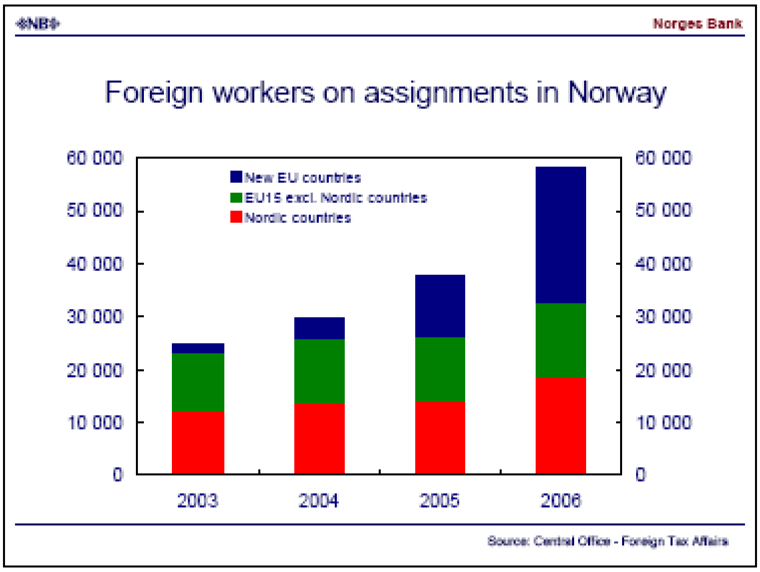
Following a long period of expansion, international financial markets were marked by unrest around the end of February. It is still too early to say whether the turbulence signals a weakening of global growth prospects.



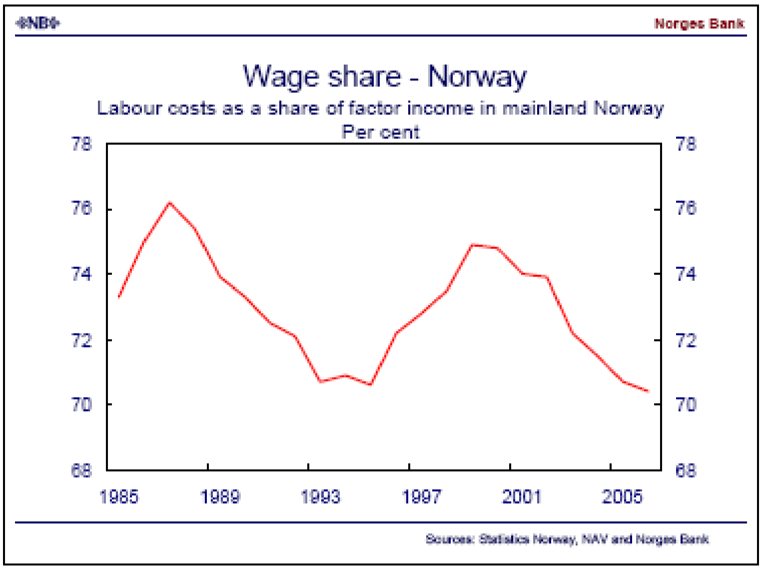
Increased integration of China, India and other emerging economies into world trade, in conjunction with lower tariffs and reduced trade barriers, has led to a decline in prices for imported finished goods. This effect has been strengthened by a significant increase in the share of imports from low-cost countries. For example, clothing and footwear, audiovisual equipment, furniture and white goods have shown very strong price declines.



Low prices for imported consumer goods, combined with high prices for our commodity exports, have resulted in a strong improvement in Norway's terms of trade. Since 2002, the terms of trade have improved by about 40 per cent. A similar situation has not been seen since World War I, when earnings in the shipping industry and other export industries were exceptionally high for a period.

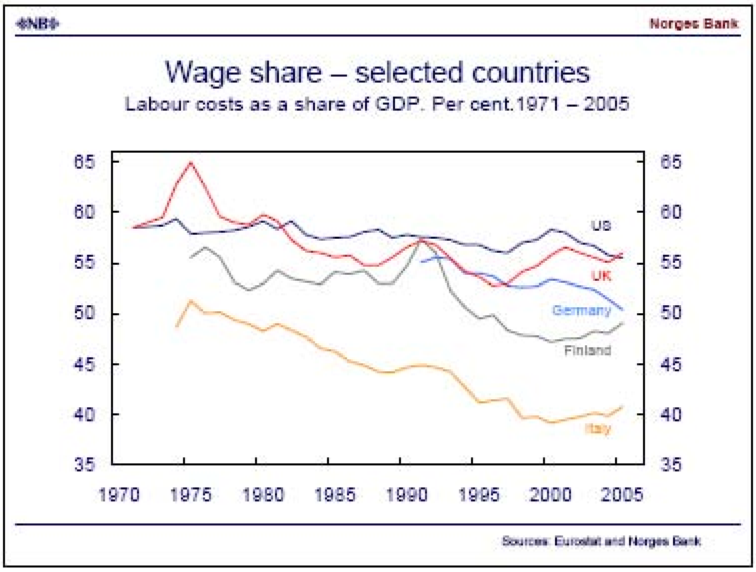


The supply of foreign labour has increased markedly after EU enlargement in 2004. Over the past two years, these labour inflows have accounted for more than 30 per cent of growth in our labour force. Norwegian companies have also been able to be considerably bolder in undertaking new assignments and investments knowing that they can procure labour throughout Europe. In addition to increased labour inflows from Poland, Lithuania and other central European countries, we have long benefited from inflows of labour from Sweden. Many workers are on temporary assignment and their consumption is primarily concentrated in their home country. The Norwegian economy has seen a net capacity increase.

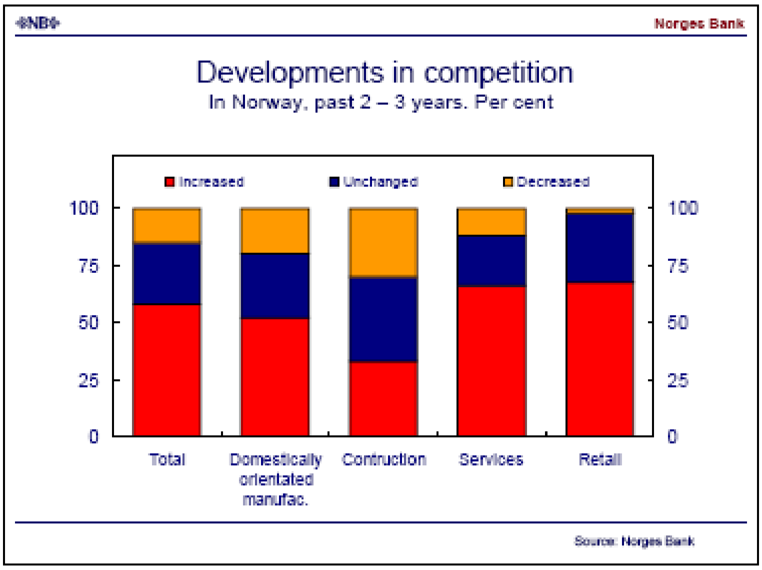


Inward labour migration delayed the fall in unemployment in this expansion. It has also reduced bottlenecks in the economy and curbed the impact of the fall in unemployment on wage growth. Labour inflows have also had a dampening effect on wage growth, probably because the wage level of foreign workers is somewhat lower than for Norwegian labour.

Moderate wage growth has reduced labour costs' share of mainland business-sector income, particularly in tradable goods sectors. In manufacturing, the wage share has shown a trend fall since the mid-1990s and the level has been the lowest since 1970 in the past few years.

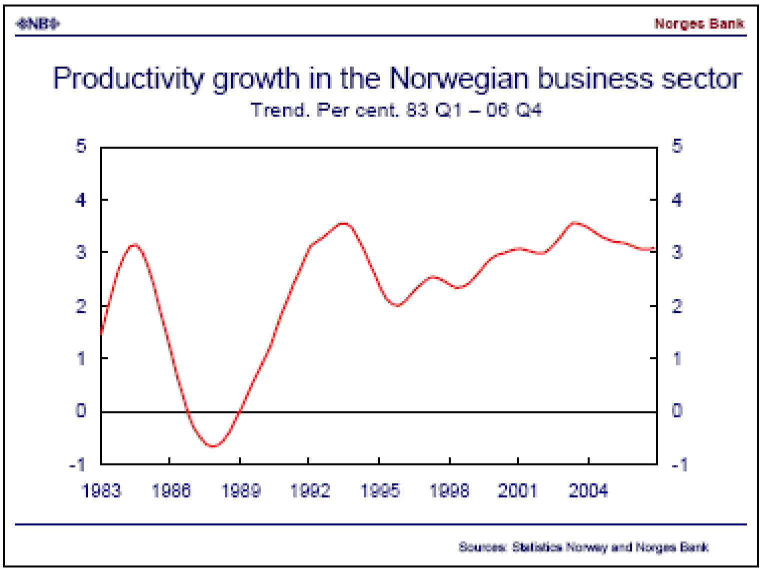


The wage share has fallen also in many other OECD countries. Emerging economies' entry into global trade has resulted in a sharp increase in the supply of labour. The result has been a fall in the global price of labour relative to the return on capital. The wage share equilibrium may therefore have been reduced. Increased possibilities for relocating production abroad may have weakened labour's bargaining power and moderated pay demands.



During the current upturn, we have also seen that the rise in prices for domestically produced goods and services has been lower than implied by historical relationships between inflation and wage and productivity growth. Increased competition in product markets may have dampened the rise in prices.

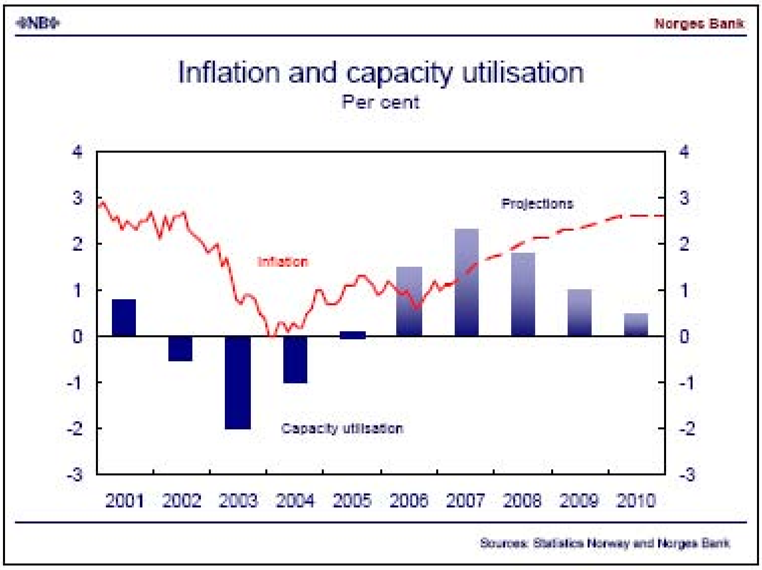
In a survey from Norges Bank's regional network 58 per cent of the companies responded that competition has increased in the past 2-3 years, while only 15 per cent reported that competition has decreased. In retail trade and services, almost 70 per cent responded that competition has intensified. Many of the companies that experience increased competition attribute this to the entry of more operators, including foreign operators, into the market.



The Norwegian business sector has been quick to integrate information technology. This applies both to companies competing on international markets and those supplying goods and services to the domestic market. In comparison with other countries, it is particularly productivity gains in banks and other service sectors that stand out. Examples are automated processes and swifter payments in the financial industry and improved inventory and management systems in commerce and transport.

In sum, these positive supply side shocks have increased the growth capacity of the Norwegian economy, and have played their part in keeping inflation at a low level.

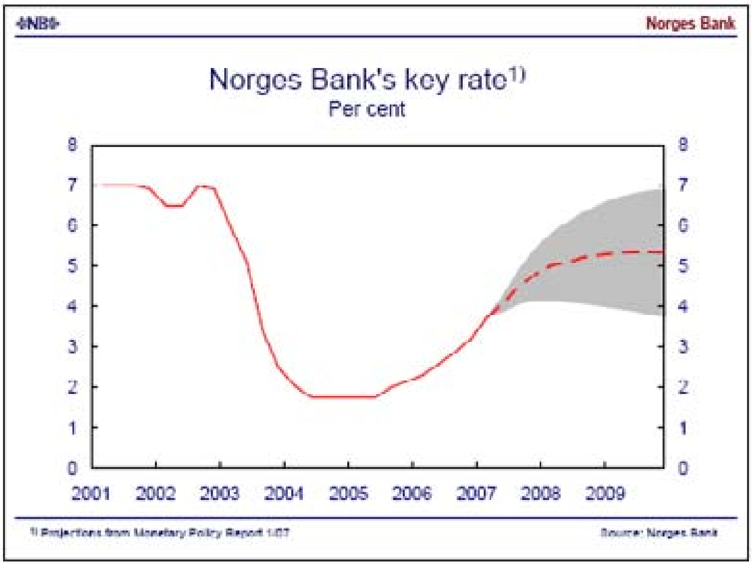
Monetary policy assessments



Monetary policy influences the economy with a lag. Norges Bank sets the interest rate with a view to stabilising inflation close to the target in the medium term. The interest rate path should provide a reasonable balance between the path for inflation and the path for capacity utilisation.

When we reduced the interest rate in 2003, demand and output rapidly picked up. However, it took a long time for employment to rise and the next phase from a pick-up in employment to a fall in unemployment was also long. But now the upturn has entered into a mature phase. The enterprises in our regional network report that capacity constraints are now limiting further growth. Unemployment has fallen markedly over the past year. Wage growth appears to be rising, but so far only gradually. Prices for many inputs and services and building materials are rising markedly. Consumer price inflation is also expected to pick up further ahead. Thus, interest rates are rising.

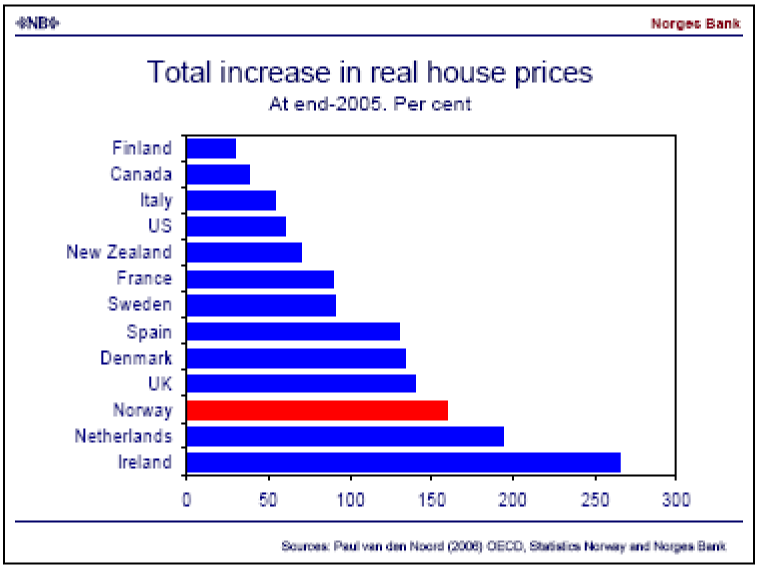
The experience of previous business cycles has shown that wage and price inflation may increase markedly in a late phase of the upturn. Higher interest rates will counter such a development. However, we must also prevent inflation from becoming entrenched well below 2.5 per cent. We will therefore be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low. Positive supply-side conditions that have held down inflation so far suggest a gradual approach, so that we can assess the effects of interest rate increases and other new information on economic developments.



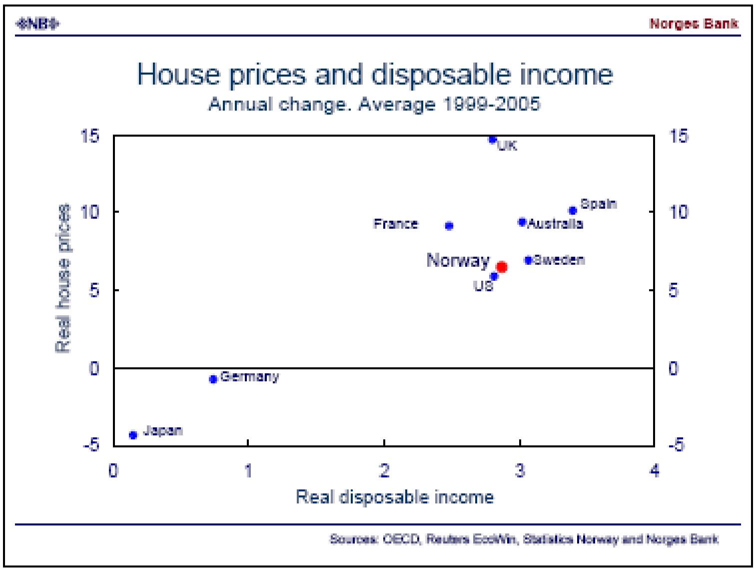
At the meeting on 15 March, Norges Bank's Executive Board presented the interest rate path shown in the chart. The Board decided that the key policy rate should lie in the interval 4-5 per cent in the period to the publication of the next Monetary Policy Report on 27 June, conditional on economic developments that are broadly in line with projections. Furthermore, the key policy rate is expected to move up to about 5 per cent around the end of 2007. Economic developments are uncertain. The uncertainty surrounding the interest rate ahead is illustrated by the shaded area in the chart, which is intended to capture the outcome with a 70 per cent probability.

Long-term interest rates, income growth and house prices

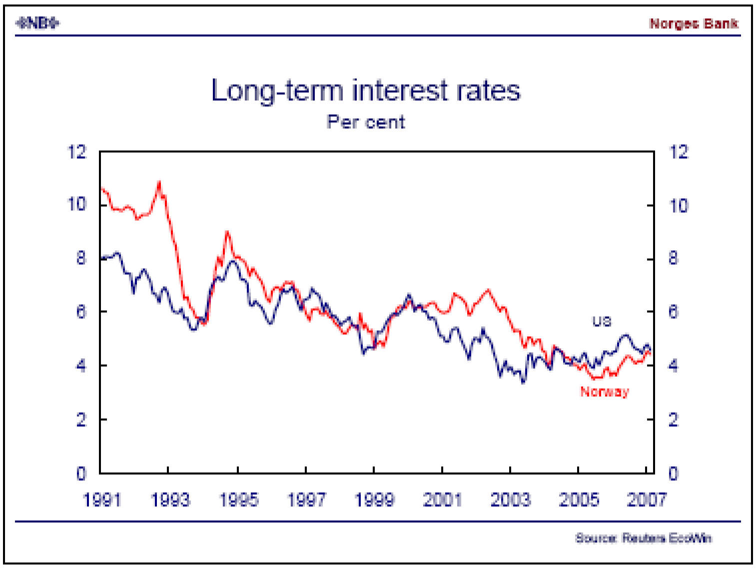
Favourable economic developments in Norway have had an impact on developments in our property markets. House prices have risen sharply over the past 14 years. Real house prices have almost trebled. The rise in house prices has been considerably stronger than earlier and has spanned a long period. With the exception of a few months in 2003, house prices have risen continuously since 1992. This is the second longest period of rising real prices since 1819. Statistics for earlier years do not exist.



Norway is not the only country where house prices have shown a strong rise over a long period. House price inflation has been particularly high in Ireland and the Netherlands, but Denmark, the UK and Spain also stand out. The countries where house price inflation has been high are the same countries where economic growth has been strongest.

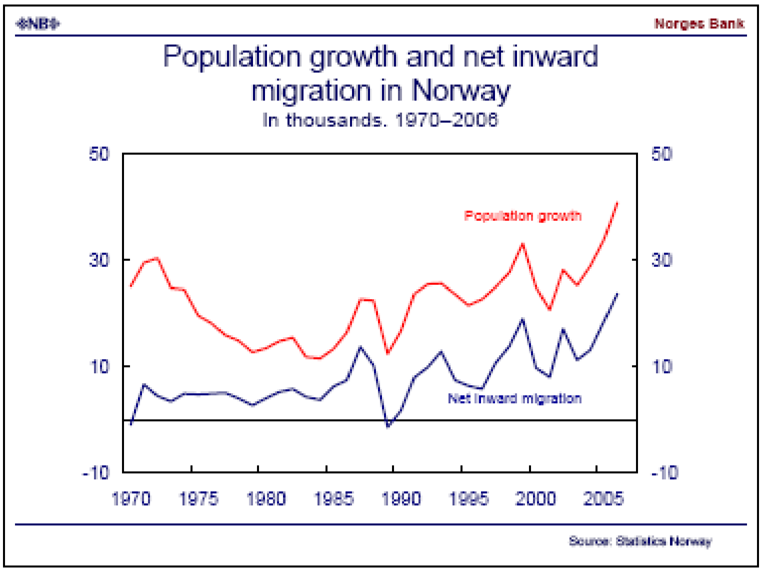


Since prices are rising in tandem in many countries, it is natural to look for common driving forces. With increasing cross-border flows of intermediate goods, capital and increasingly so labour, prices will largely reflect growth and competition in the global economy. If capital or labour becomes too expensive in one country, businesses can relocate production. Prices for fixed factors of production, such as property, will on the other hand reflect income developments in different countries. Consequently, the rise in property prices will tend to be highest in those countries where income growth is highest.



External and domestic interest rates are low in an environment of solid growth. Long-term interest rates have fallen sharply both in nominal and real terms since the beginning of the 1990s. Inflation has declined and contributed to a fall in nominal interest rates. A more stable inflation environment also results in lower real interest rates when investors become more certain about returns. Furthermore, it would appear that high saving in some parts of the world is pushing down long-term interest rates. Saving is high both in oil-producing countries, China and other Asian countries.

Long-term interest rates in Norway largely shadow external interest rates because like other countries Norway is keeping inflation in check. Norwegian households primarily finance house purchases by means of floating-rate loans. Long-term interest rates are still of considerable importance because they provide information about the future path of short-term interest rates that borrowers can expect over time. Unusually low short-term interest rates have probably also boosted the rate of increase in house prices in recent years, but this effect will be reversed when the interest rate is raised to a more normal level. Short-term interest rates have influenced the path for house prices over the past 15 years, but periods of low interest rates are followed by periods of higher interest rates. Norges Bank's key policy rate is therefore of limited importance for house price inflation over a period of 15 to 20 years.

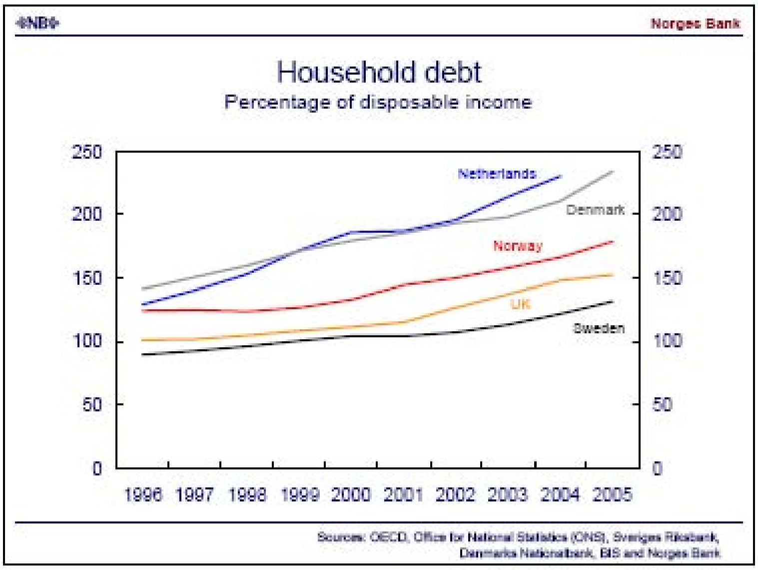


The housing stock in Norway, which numbers a good 2.2 million dwellings, shows little change from one year to the next. As a result, higher demand for housing will primarily translate into higher prices in the short term. In the 1990s, housing starts in Norway were fairly low in relation to growth in the number of households. Moreover, population growth has been higher in recent years, largely reflecting a high level of immigration. In 2006, the population increased by more than 40 000 and the number of households by roughly 30 000.

Furthermore, migration patterns in Norway follow the business cycle. Migration to densely populated areas is now rising. Demands for high standards and new building regulations have also pushed up housing construction costs and thereby house prices.

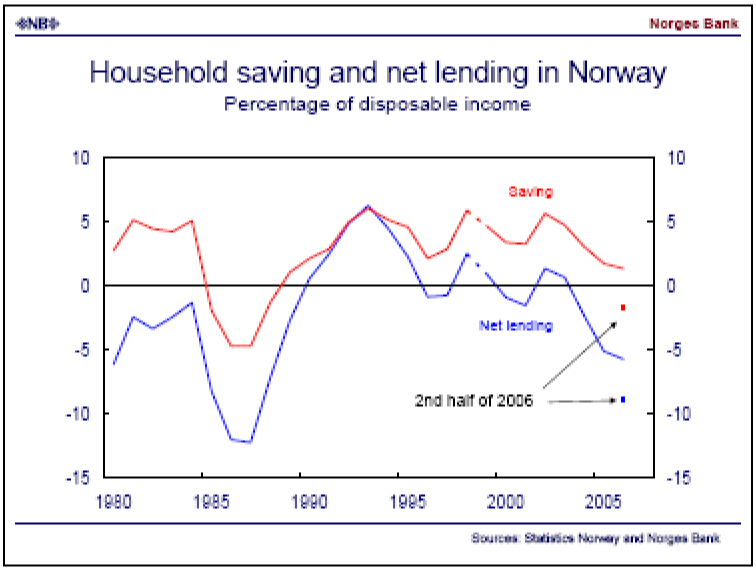
The main determinants of house price inflation have long been income, unemployment, interest rates and residential construction. Over the past few years, inward migration and domestic migration patterns may also have contributed. In the past year, however, house price inflation has been higher than implied by these factors. A large share of the increase in 2006 cannot be explained by previous patterns. Developments since the beginning of the 1990s may have engendered expectations that house prices will only continue to rise. This may have increased house purchases for pure investment purposes and induced younger buyers to enter the housing market earlier than otherwise.

The housing market may now be in a state of euphoria.



The rise in house prices has been accompanied by a sharp increase in household debt. In Norway, household debt is now almost twice the level of disposable income, and the debt to income ratio is the highest ever. It is higher than in Sweden and the UK, but lower than in Denmark and the Netherlands.

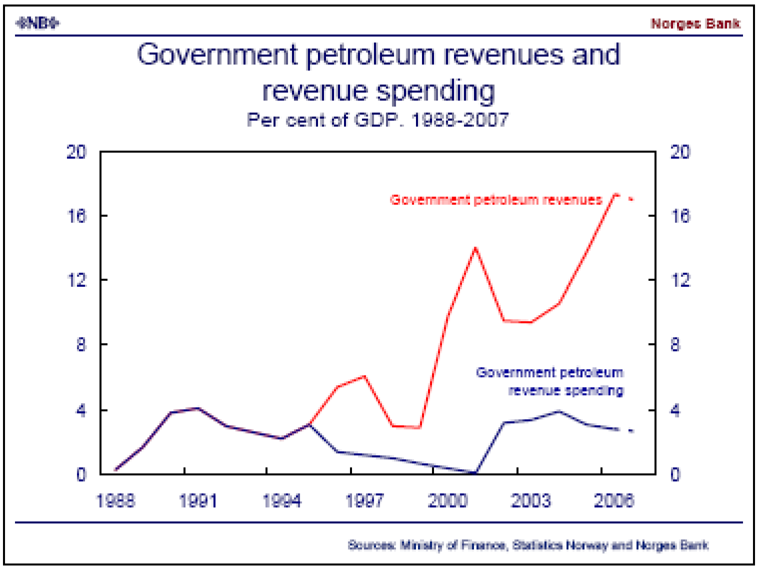
Norway is among the countries with the highest share of owner-occupied dwellings, at around 80 per cent. This high proportion partly accounts for the high mortgage debt of households. In recent years, new loan products have also been launched, facilitating mortgage equity withdrawal. Housing wealth has become more liquid. Borrowers have greater scope for choosing repayment profiles. We cannot identify the exact level of household debt that can be sustained over time, but the rapid build-up of debt makes households more vulnerable.



Housing investment for the household sector as a whole is now being fully debt-financed, which means an increase in net debt. It would appear that household saving has fallen markedly in Norway in the recent past. Saving was negative in the latter half of 2006, which is the first time saving has fallen since 1988. The pronounced fall in saving indicates that households are taking greater chances.

At the same time, government revenues and savings are high. The long period of prosperity and government budget surpluses may have engendered a sense of security which is also affecting household saving and house purchases.

Petroleum and the Government Pension Fund – Global



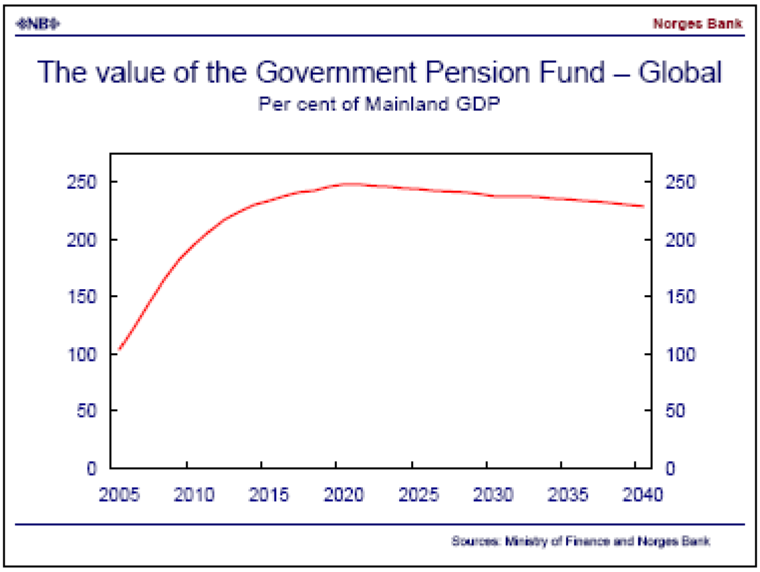
High oil and gas production and high prices, combined with high returns, have resulted in a rapid rise in the value of the Government Pension Fund in recent years.

The Norwegian authorities have been successful in ensuring that the bulk of the petroleum wealth benefits Norwegian 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 been important. 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 spending 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 foreign investments as a way of transferring capital from one account to another – from petroleum to foreign securities. By doing so, we diversify risk.

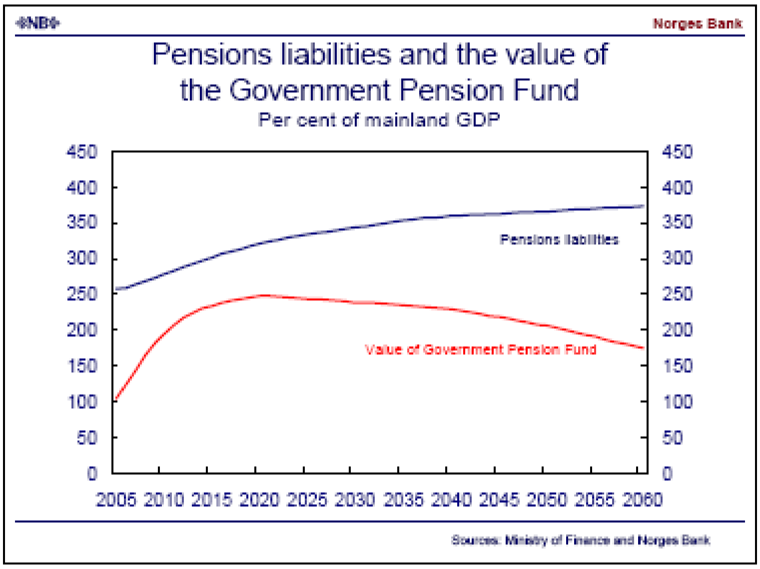
Second, the size of the cash flow from petroleum activities varies. If petroleum revenues were to be spent as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy.

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



The establishment of the Government Pension Fund – Global and the spending guidelines for petroleum revenues are part of the response to these challenges.

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 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, which clearly shows that sound management of our petroleum wealth generates considerable benefits. 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.

I have talked about some of the supply-side shocks that have had a positive effect on the Norwegian economy. Norway is now reaping the benefits of globalisation through increased international trade and freer labour flows across national borders. Globalisation also has its challenges and although I have not delved into these in my speech today, I would be delighted to discuss these and other issues with you in the question and answer session.

Thank you for your attention!