

## **Svein Gjedrem: The economic situation, global uncertainty and monetary policy**

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at a conference of the Norwegian Public Service Pension Fund 2008, Sandefjord, 16 April 2008.

*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 13 March and in Monetary Policy Report 1/08 and NBIM Annual Report 2007.*

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There has been turbulence in global financial markets since last summer. What began as isolated losses in a small segment of the US housing market has gradually had substantial spillover effects in the global financial system. Uncertainty and the fear of further losses are still reflected in the markets. It has also become increasingly evident that the turbulence will result in weaker global growth. Only a week ago, the IMF presented forecasts for global growth that were clearly weaker than those presented just a few months earlier.

So far, the direct consequences of the turbulence have been limited in Norway. However, continued turmoil and weaker global growth will affect the Norwegian economy. I will return to this later. Let me begin with some brief remarks about the current situation in the Norwegian economy.

### **The economic situation**

Since the mid-1990s, inflation in Norway has been low and stable and it has been fairly close to, but somewhat lower than, the target of 2.5 per cent, unlike the situation in Norway in the 1970s and 1980s when inflation was high and showed wide fluctuations.

The Norwegian economy has on the whole also exhibited solid growth since the beginning of the 1990s, despite a mild downturn in 2002 and into 2003. Over the past four years, the mainland economy has been in a strong upturn, with average annual growth well above 4 per cent. Preliminary accounting figures suggest that growth was particularly strong in 2007. Information from Norges Bank's regional network also indicates that growth was strong in 2007, but that it slowed somewhat towards the end of last year.

Employment has risen sharply over the past two years. In both 2006 and 2007, the number employed increased by over 3 per cent. The number employed increased by 93 000 between 2006 and 2007, the highest increase for decades. Employment growth has partly been offset by a decline in unemployment and an increase in the labour supply, as a result of increased labour participation among the existing population and labour inflows. Unemployment has not been as low since the last half of the 1980s, and the number of vacancies is record high. The labour market is tight.

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 opening of the labour market to the new EU countries has provided us with access to a reserve of labour. There has been a substantial flow of labour into Norway. Labour migrates to locations where potential earnings are highest. Growing numbers of workers are moving to Norway and establishing residence here. Many workers are only here on short-term assignments and will perhaps move on when the job is done and when there is an economic turnaround. In 2007, Norway's population increased by about 55 000, with net inward migration coming to 35 000. This is the highest population increase ever registered.

Second, higher imports from low-cost countries and high prices for a number of our export goods have resulted in a considerable improvement in Norway's terms of trade since the end of the 1990s. Prices for oil and gas, freight, fish, industrial commodities and engineering products have increased markedly. The terms of trade have improved by about 40 per cent since 2002. Recently, however, Norway's terms of trade have fallen somewhat again as the rise in prices for some export goods has slowed. Slightly higher import prices are also having a negative impact.

Third, businesses in Norway have become more efficient, lowering their production costs and making it profitable to expand their workforces. This applies to both companies competing on international markets and those supplying goods and services to the domestic market. Compared with other countries, productivity gains have been particularly strong in the banking industry and other service sectors. The business sector has been quick to adapt and change, and to make use of new technology that is available in an international market. This is probably due the modernisation of the functioning of the economy through the 1980s and 1990s, which resulted in more efficient markets.

### **Turbulence in financial markets**

The financial market turbulence may result in a reversal of some of the positive driving forces in the Norwegian economy.

The turbulence was probably triggered by falling house prices in the US. There were reports of an increase in defaults on subprime mortgages from the second half of 2006. Securities portfolios had been developed around these mortgages. Uncertainty arose among bankers and investors who directly or indirectly were exposed to losses on these mortgages. This resulted in a sharp decline in prices for these securities, which then spread to a range of mortgage-backed instruments.

In the course of summer 2007, it became clear that the losses had spread to banks, funds and financial establishments in Europe, Asia and the US. The turbulence also spread to other financial market segments. Few knew who was exposed to losses, and financial market participants started to question counterparties' financial situation, and held on to their money.

Many banks have sustained substantial losses on their own investments related to these markets, but have also had to bring back onto their books loans from companies they had established. This has reduced their capacity and willingness to provide new loans, and a number of the largest financial institutions in both the US and Europe have had to raise substantial new capital.

Crises and turbulence are built into the workings of the market. The search for yield and market shares may at times become too intense. One lesson from the turbulence so far is that developments in the financial system, with new financial products combined with a possible lag in legislation and regulation, have rendered the financial system vulnerable. The turbulence has also shown that in a situation of widespread uncertainty and turmoil, different segments of the financial market are interconnected, which is not evident under normal circumstances.

An important aspect of the current turbulence is the sharp increase in the price of interbank liquidity. History shows that there have been periods where the spread between banks' funding costs in money markets and risk-free interest rates has increased sharply, but these periods have been relatively short. The persistence of the wide spreads today suggests that banks' confidence in other banks' credit quality has been reduced. This would also indicate that banks prefer to hold substantial liquidity in order to limit their own funding costs. The persistently wide spreads is also an indication that this episode of turbulence is not yet a closed chapter.

## Orientation of monetary policy

Monetary policy in Norway is oriented towards annual consumer price inflation of close to 2.5 per cent over time. Inflation has been expected to pick up for some time. Since summer 2005, the key policy rate has been raised by 3.5 percentage points to 5.25 per cent.

Norges Bank's interest rate setting is based on two main criteria for future interest rate developments. First, the interest rate is set with a view to stabilising inflation close to the target in the medium term. The horizon will depend on disturbances to which the economy is exposed and their effects on prospects for the path for inflation and the real economy. Second, the interest rate should provide a reasonable balance between the path for inflation and the path for capacity utilisation. In the assessment, potential effects of property prices and the krone exchange rate on the prospects for output, employment and inflation are also taken into account. The various factors that influence interest rate prospects are now pointing in different directions.

As a result of the financial market turbulence and uncertainty about developments in the US, market expectations concerning economic growth and central bank key rates have fallen, in both the short and long term. The Federal Reserve has reduced its key rate by 3 percentage points since September 2007 and interest rates are again moving down in the US and a number of other countries. Interest rates are being cut to address weaker economic growth prospects. However, in view of the high level of unsold homes and properties in the US, it is uncertain whether the interest rate weapon will be as powerful as in the past. Thus, there is a risk that the US economy is entering into a downturn in spite of the interest rate cuts. Should weaker developments in the US lead to a broad-based pause in global growth, there may be a number of repercussions for the Norwegian economy.

First, a downturn in the world economy may adversely affect 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 weaker growth prospects 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.

Falling external interest rates have resulted in a wider interest rate differential against other countries. This may lead to a stronger krone, but there are also opposing forces in the foreign exchange market. In the long run, the krone exchange rate is determined by changes in the terms of trade and permanent differences between domestic and external inflation and productivity. But the krone exchange rate also shows monthly and yearly fluctuations. The krone was strong towards the end of the previous cyclical expansion, but depreciated when interest rates declined in 2003. Thereafter, the krone appreciated again as growth in the Norwegian economy recovered. Over the past two years, the krone has appreciated by close to 5 per cent.

Even though the krone has appreciated, inflation has picked up and is now fairly close to 2.5 per cent. While different measures of inflation as recently as last year were below 1½ per cent, the same measures are now between 2.1 and 3.3 per cent. The rise in the consumer price index (CPI) reflects the increase in electricity prices. Underlying inflation has also increased and is now assessed to be between 2 and 3¼ per cent. Prices for domestically produced goods and services are rising at a particularly fast pace. At the same time, prices for imported consumer goods are no longer falling. Higher inflation is expected one to two years ahead.

At the same time, growth in the Norwegian economy is strong. An ample supply of labour will allow growth in the Norwegian economy to hold up for a period ahead. Capacity utilisation is nevertheless likely to decline. Weaker growth in the world economy may have an impact on developments in the Norwegian export industry, which may gradually spill over to other business sectors in Norway. Household saving is negative and over time households must be expected to seek to redress their financial imbalances. Interest rate developments and a weaker housing market will probably have a dampening impact on demand for goods and services and push up saving. On the upside, we expect sharp growth in government spending, with a marked increase in government purchases of goods and services. Petroleum investment is projected to remain high. Current information nonetheless points towards somewhat slower growth further into 2008.

In the monetary policy reports, the results of this assessment are presented in the form of this chart, which shows the baseline scenarios for the interest rate, inflation and capacity utilisation in the economy. Monetary Policy Report 1/08 noted that the outlook and the balance of risks suggest that in the near term the interest rate should be set somewhat higher than projected in Monetary Policy Report 3/07. The prospect of higher price and cost inflation will in the short term more than outweigh the effects of weaker growth in the world economy.

There is considerable uncertainty surrounding the projections. The projections for inflation, output, the interest rate and other variables are based on our assessment of the current economic situation and our perception of the functioning of the economy. The uncertainty surrounding the projections for the interest rate, inflation and capacity utilisation is illustrated by fan charts. The wider the fan charts are, the more uncertain the projections are.

At the monetary policy meeting on 13 March 2008, Norges Bank's Executive Board decided to keep the key policy rate unchanged at 5.25 per cent. The press release issued after the meeting states that the Executive Board considered increasing the interest rate as an alternative, but that an overall assessment indicated that it was appropriate to keep the interest rate unchanged. Reference was also made to the analyses in Monetary Policy Report 1/08, which suggest that the key policy rate may be raised further in the period to summer.

The Executive Board's strategy is that the key policy rate should be in the interval 5 – 6 per cent in the period to 25 June, unless the Norwegian economy is exposed to major shocks.

## **The Government Pension Fund – Global**

As I am addressing pension funds today, I must also take this opportunity to discuss the Government Pension Fund – Global.

Heightened uncertainty concerning the financial system and global growth prospects is also having an impact on the Government Pension Fund's investment markets. In recent months, price volatility in both equity and fixed-income markets has increased. The fall in equity prices, even after several years of gains, has drawn focus on variations in the Fund's value.

In such a situation it is important to step back and remind ourselves of the basis for the investment strategy that was chosen for the Fund. The strategy must be based on the Fund's distinctive features, in particular the Fund's long investment horizon. There is little risk that its owners will make substantial withdrawals from the Fund over short periods. Other funds or individual investors may for various reasons have to reduce their holdings or pull out of capital markets at an unfavourable time. This may be because the investments are leveraged or that a fund is subject to regulatory constraints or simply that a long-term strategy is influenced by short-term assessments.

In addition to its large size and long future life, the Fund is not earmarked for particular obligations unlike traditional pension funds. As a result, the Fund has a higher risk-bearing

capacity than other comparable funds. The Pension Fund can thus to a larger extent invest in financial instruments that may vary more in value, but provide a higher expected return, which in practice means investing in equities. The allocation to equities will now increase from 40 to 60 per cent.

If returns vary across different markets and market segments, spreading investments can improve the trade-off between risk and return. This is why the Fund is expanding its portfolio, not only in terms of its geographic exposure, but also the depth of its investments in individual markets.

The Fund's strategy results in a very broad market exposure. This limits the Fund's exposure to large losses on individual investments or group of investments that are influenced by the same or closely related risk factors. Losses on individual investments or main groups of investments will offset each other in a well diversified portfolio. The investment strategy should be robust both under normal market conditions and in periods of abnormal, turbulent market conditions.

Twelve years have now elapsed since the initial capital transfer to the Government Pension Fund – Global, which was then called the Government Petroleum Fund, and the Fund has grown and developed faster than envisaged. The Fund's future is still substantially longer than its short history. A large and growing fund such as the Government Pension Fund – Global cannot adapt its asset positions to the momentary picture, but rather the contrary. It is important that the strategy remains firmly in place through turbulent periods.

Moreover, we must expect that the shocks to which financial markets will be exposed over the next decades will be different from those we know from history and our own experience of recent decades. History will nevertheless be our most important strategy assessment tool. We know the past better than the future. If the Fund's strategy is viewed from a historical perspective, for example the Great Depression of the 1930s and the oil crisis and stagflation of the early 1970s, analyses show that in the short run the Fund can survive large losses, but that the value is recouped in the course of three to five years.

Part of the Pension Fund's strategy is to rebalance the portfolio by shifting into assets that show the strongest fall in value, that is the assets where the crisis is most severe, but that historically have featured the highest long-term return potential. The Fund's own history includes a period that illustrates the importance of not changing strategy during a downswing. After the dotcom bubble burst in 2000, the value of the Fund's equity holdings fell sharply for a period. At the same time, the Fund's fixed-income investments partly offset the losses on the equity side.

Norges Bank is the operational manager of the Government Pension Fund – Global. Since the Fund's establishment, we have built up an organisation that is capable of implementing the strategy laid down by the Ministry of Finance. Pursuant to the mandate assigned to Norges Bank, we seek to generate value added in excess of the return that follows from the strategic allocation.

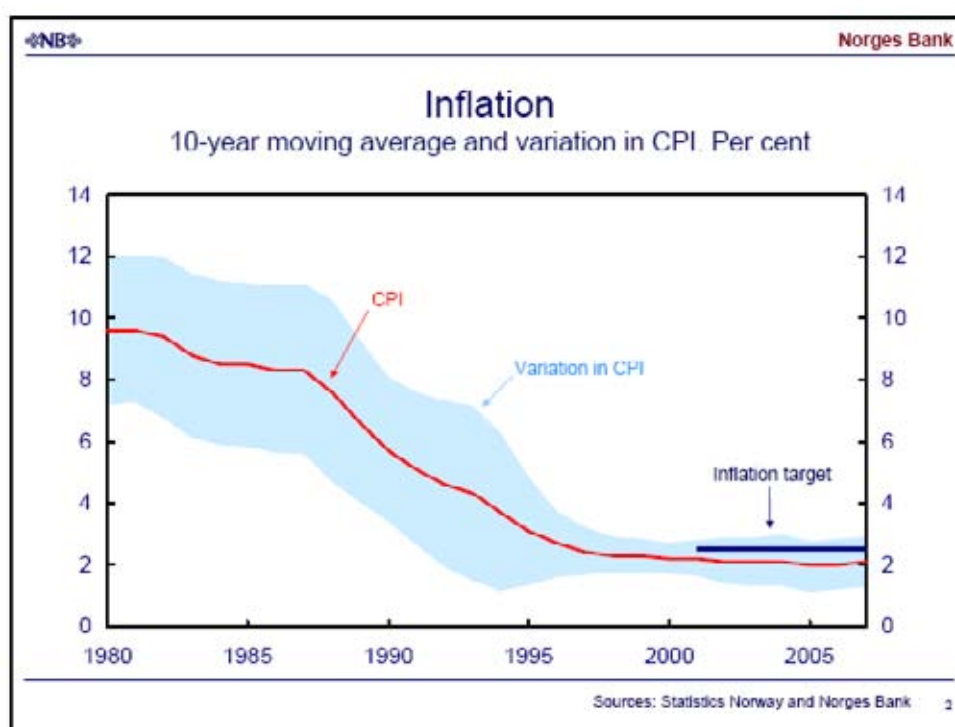
The Fund has achieved an average annual real return of 4.25 per cent since 1997. The contribution to the return from active management has averaged 0.39 per cent annually in the same period. Active management has thus made a contribution of about 9 per cent of the Fund's total return. This result has been achieved without changes in the Fund's return variability or risk exposure. Norges Bank's investment management has thus improved the risk to return trade-off. In the long run, even a small percentage increase in the average annual rate of return will have a substantial impact on the Fund's size.

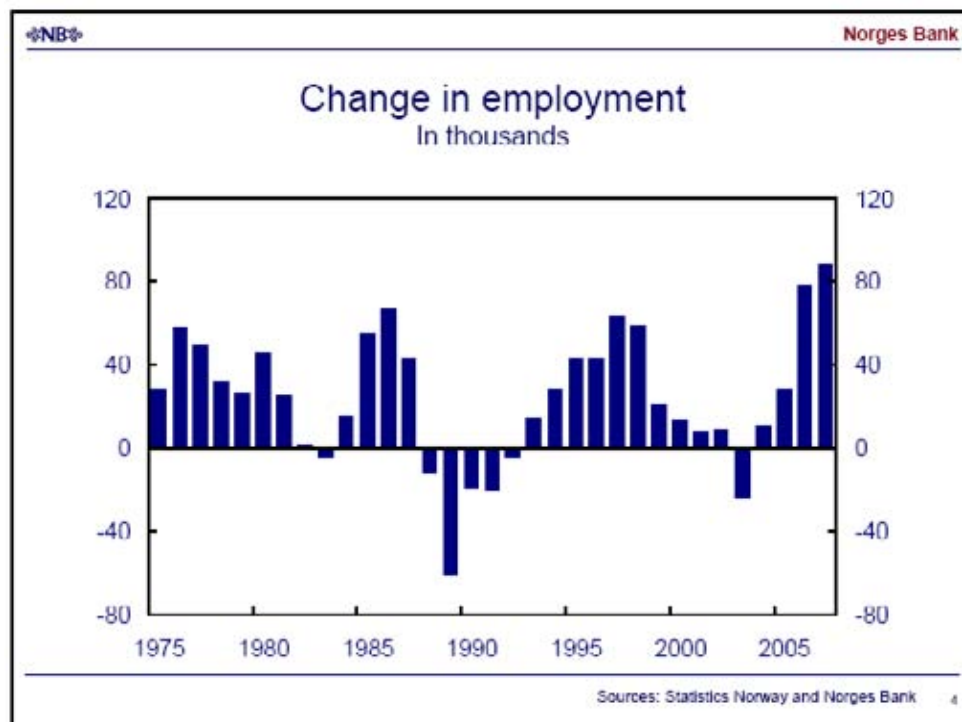
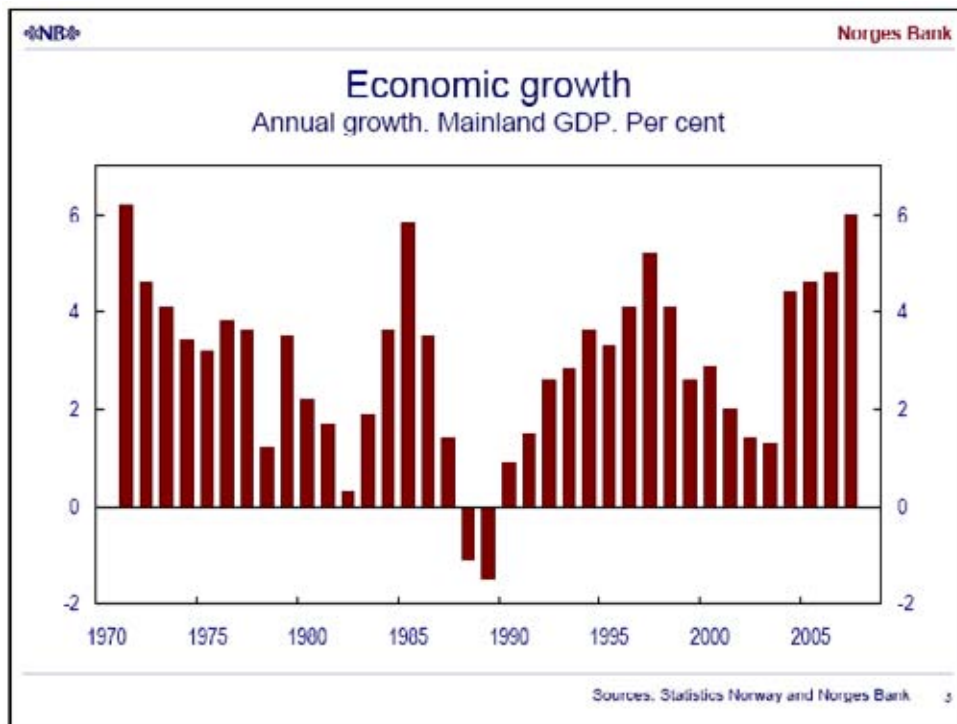
A stated goal of operational management is that a large number of investment decisions are to be taken independently of each other both at a given point in time and over time. Norges Bank will increasingly use the Fund's properties in developing investment strategies ahead, with particular emphasis on taking advantage of the Fund's size and long-term investment horizon.

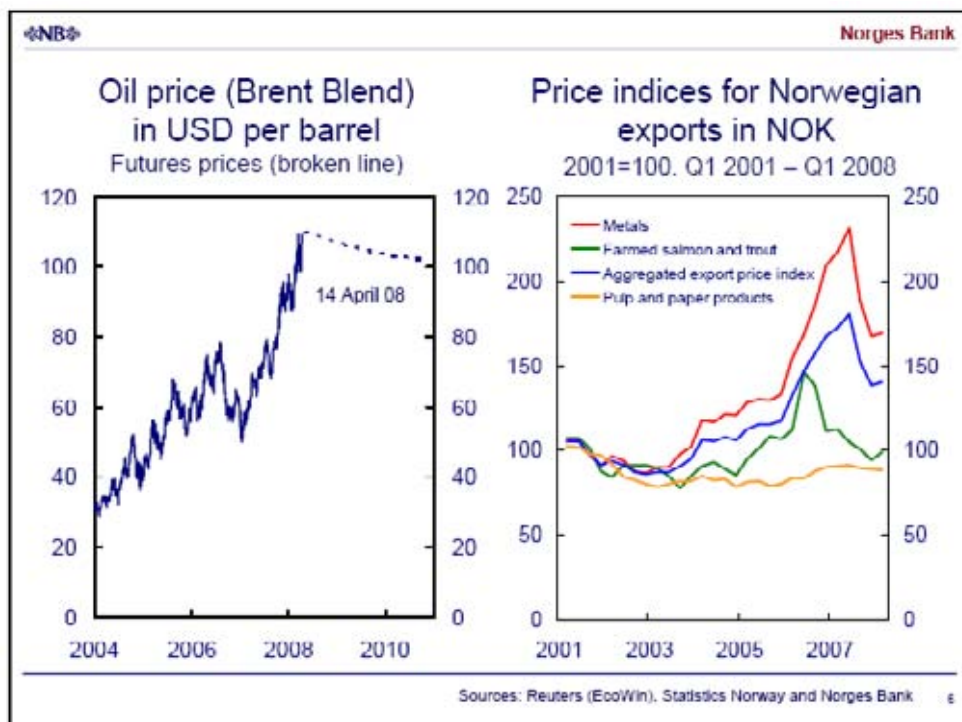
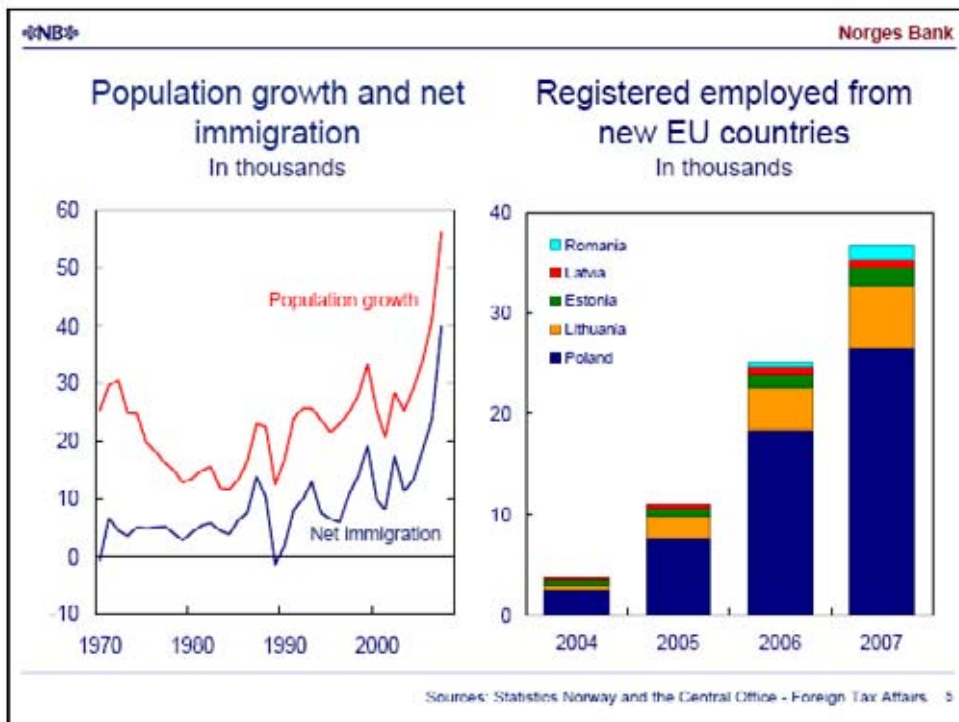
Norges Bank's mandate sets the tracking error limit at 1.5 percentage points. Given this limit, the actual portfolio return is likely to deviate by less than 1.5 percentage points from the benchmark portfolio in two of three years, but it also implies a risk that active management may reduce the return by more than 1.5 percentage points every sixth year. In light of the size of the Fund, this will be a substantial amount in krone terms. Losses from active management must be expected in periods. Losses are not necessarily an indication that active management is not conducted professionally or not using the right strategies. The performance of the Fund's investment management must be evaluated over a long time horizon.

Even if the contribution from active management was negative for the first time in the Fund's history last year, it does not change our confidence in and conviction that our organisation will contribute to achieving excess returns in the longer run.

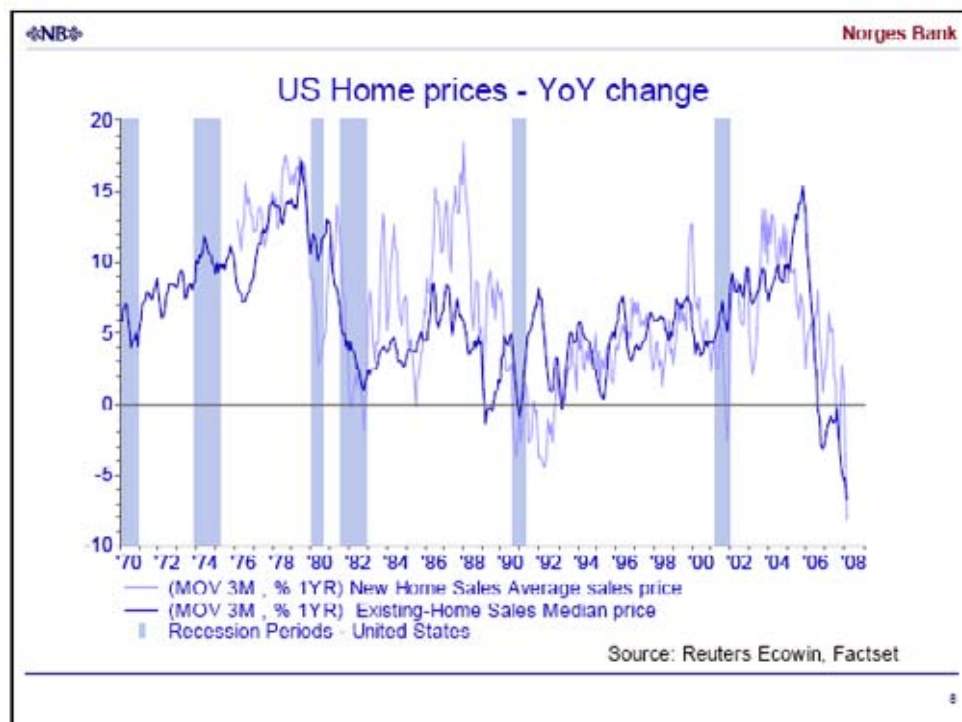
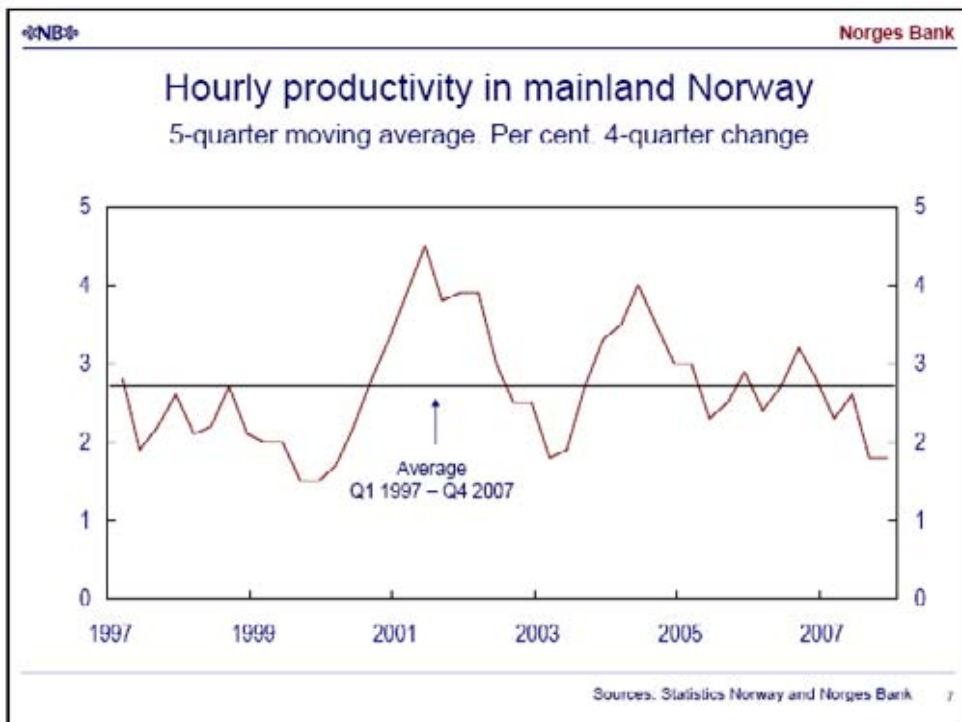
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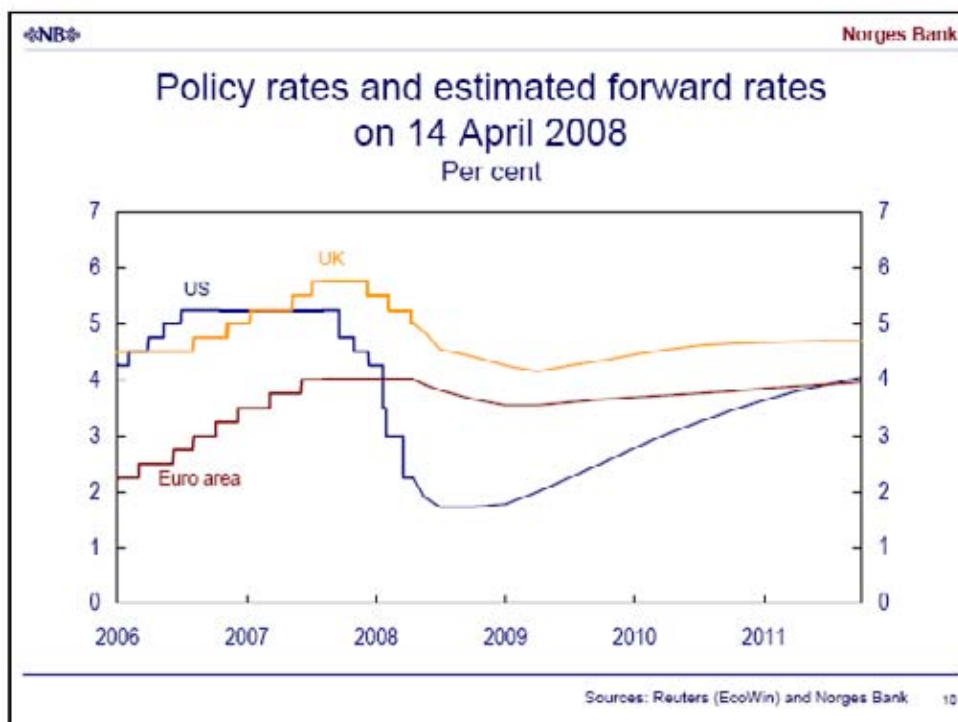
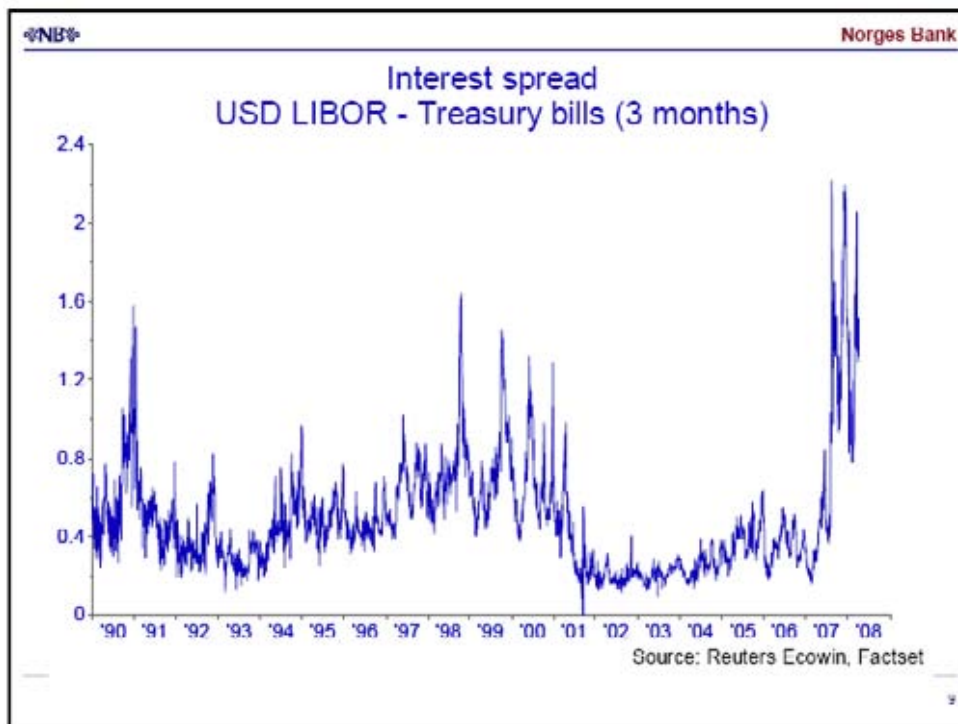












# Krone exchange rate and interest rate differential<sup>1)</sup> Index and per cent

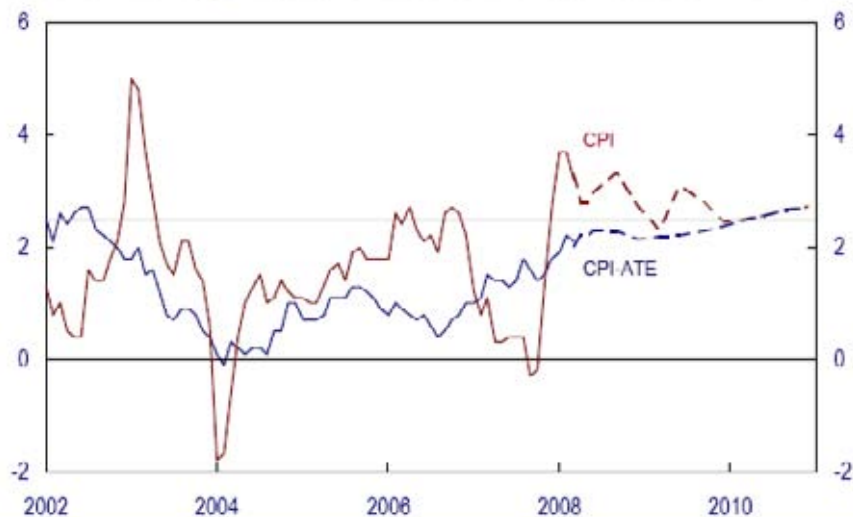


<sup>1)</sup> A rising curve denotes an appreciation of the krone

Sources: Bloomberg, Reuters (EcoWin) and Norges Bank 11

# Consumer prices<sup>1)</sup>

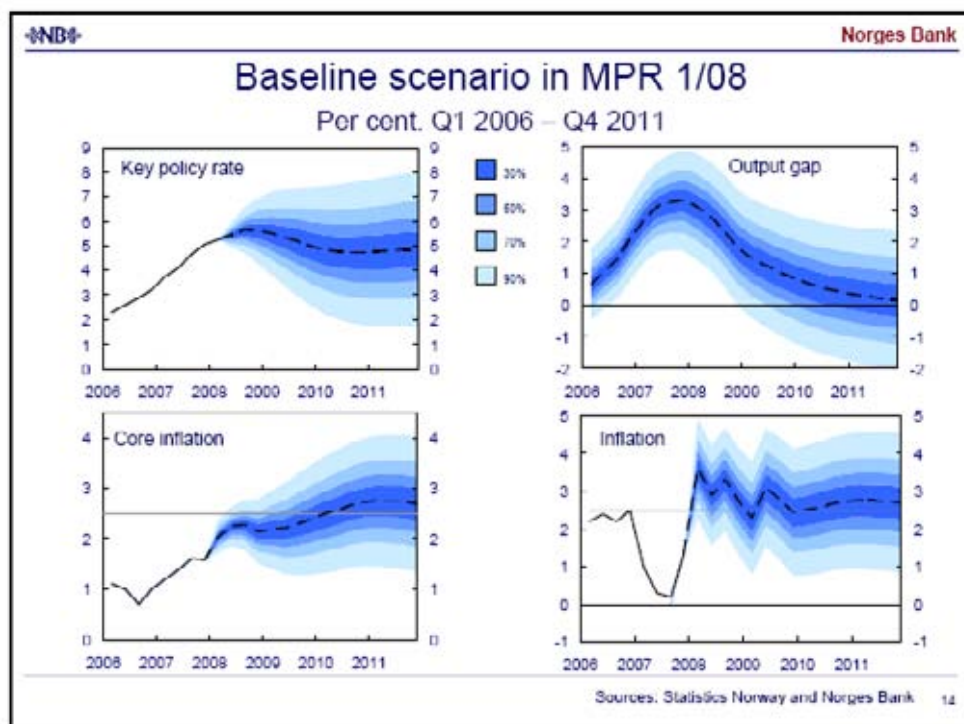
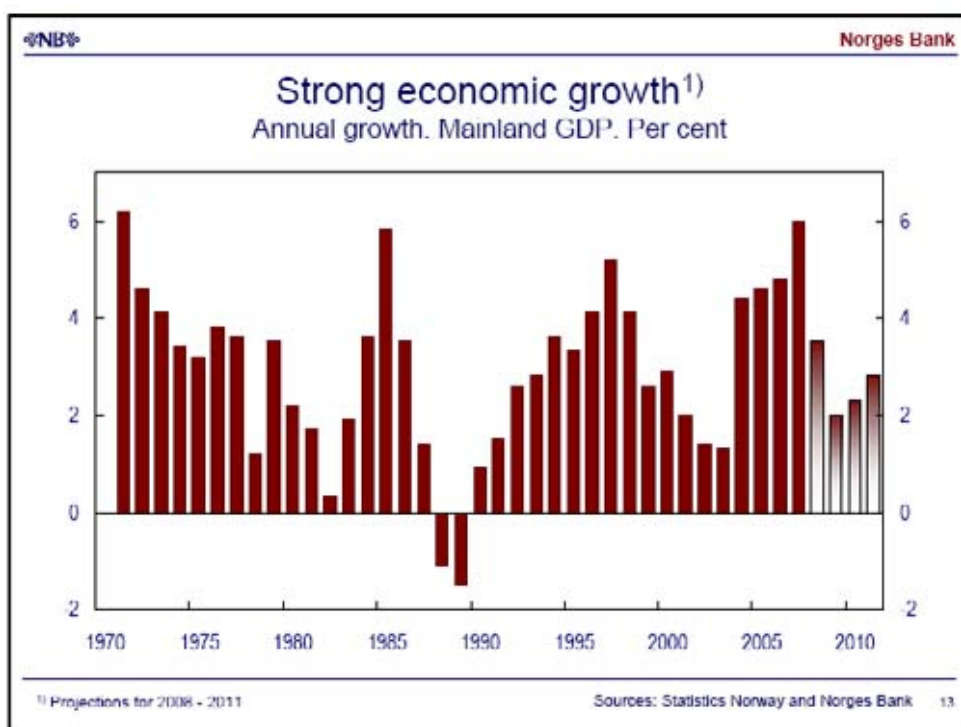
12 month change in CPI and CPI-ATE. Per cent. Jan 02 – Dec 11<sup>2)</sup>



<sup>1)</sup> CPI-ATE: CPI adjusted for tax changes and excluding energy products

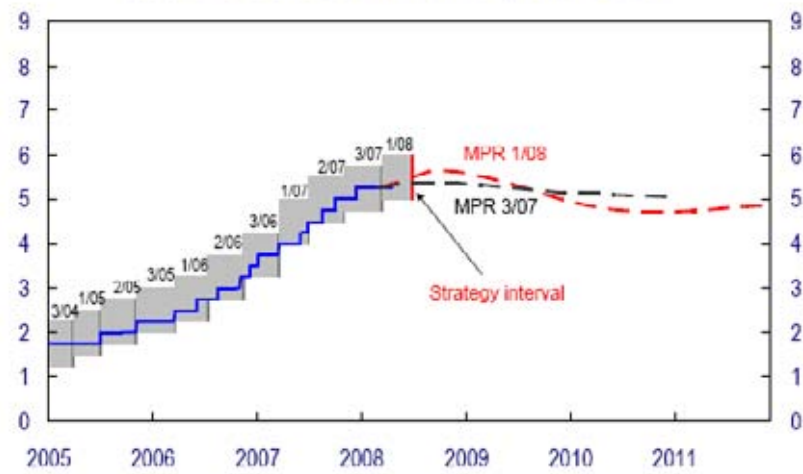
<sup>2)</sup> Projections for Apr 09 – Dec 11

Sources: Statistics Norway and Norges Bank 12



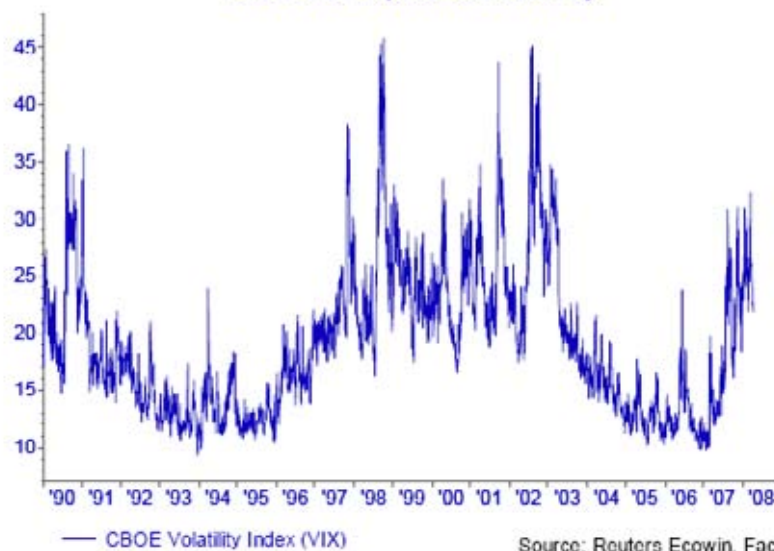
## Key policy rate

Actual developments, strategy intervals and baseline scenarios in MPR 1/08 and MPR 3/07



Source: Norges Bank 15

## S&P500 expected volatility



Source: Reuters Ecowin, Factset

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