Svein Gjedrem: The outlook for the Norwegian economy and monetary policy assessments

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at a presentation of the Monetary Policy Report 1/09 at Goldman Sachs, London, 26 March 2009.

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 25 March, Monetary Policy Report 1/09 and on previous speeches. Please note that the text below may differ slightly from the actual presentation.

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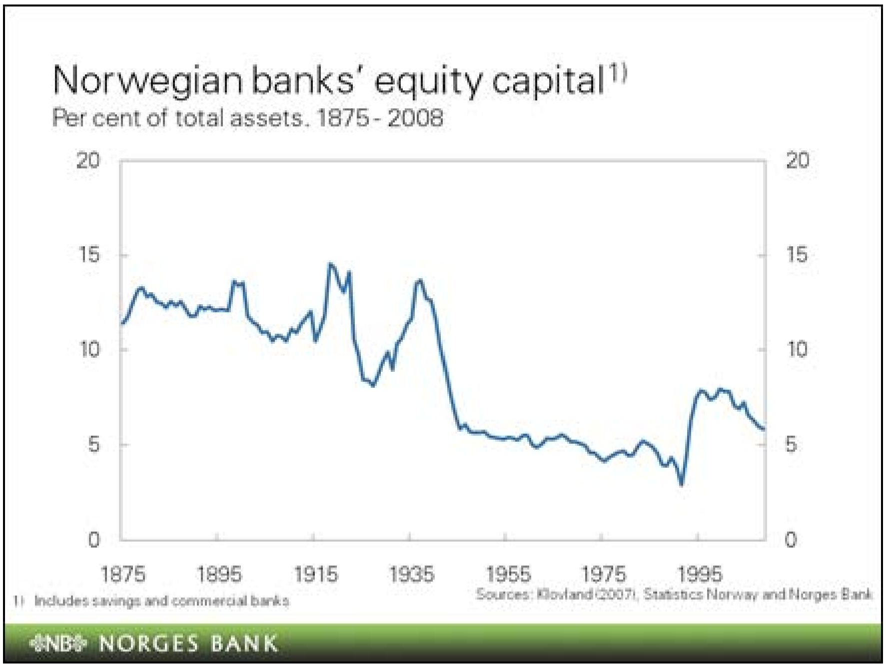
Introduction

Norges Bank's Executive Board decided yesterday to reduce its key policy rate by 0.50 percentage point to 2.00 per cent. The Monetary Policy Report, published yesterday, indicates that the key policy rate should be gradually reduced further to a level of around 1 per cent in the second half of 2009.

Financial crisis but active public measures

In September 2008, the turbulence in financial markets erupted into a full-blown global crisis. Global economic growth was already slowing, but the situation has deteriorated in the past few months of 2008. The turnaround hit hard, with synchronised effects on virtually all financial and goods and services markets, not only in the US but also in Europe, Asia, Latin America and Oceania. We are now in the deepest downturn in OECD countries in the postwar period. GDP in the OECD area as a whole is expected to fall in 2009 for the first time since the Second World War.

The prospects for the world economy are now even weaker than we anticipated at the end of 2008. International trade is contracting markedly, and it will take time before growth rebounds. Our projections for growth among our trading partners have been revised down to -3 per cent in 2009 and ¾ per cent in 2010. Moreover, the Norwegian economy seems to be contracting more sharply than projected around the monetary policy meeting in December.

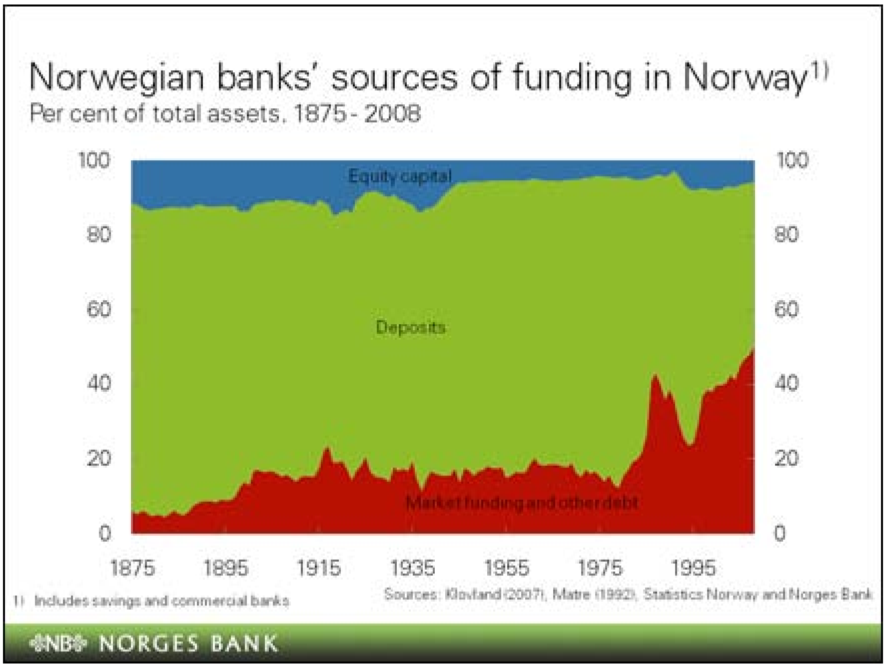


A wide range of instruments is being used in Norway to counteract the effects of the financial crisis. In order to curb the fall in activity, government expenditure will be increased by over 10 per cent this year.

Norges Bank's bank lending survey shows that banks have been tightening credit standards substantially, particularly for corporate loans. To boost the credit market a separate government fund[1] will buy private bonds.

The government has also provided loans and guarantees for exports and expanded lending limits for the Norwegian State Housing Bank and other special vehicles for government financing.[2]

Norwegian Banks' equity capital makes up only 6 per cent of their assets, which is low from a historic perspective, but not low compared with banks in other countries.[3] At present, our banks are financially sound, but they need to strengthen their core capital in order to be able to supply credit as normal. The authorities offer risk capital to the banks, including core Tier 1 capital without voting right through a newly established State Finance Fund.



Banks have become more vulnerable to distortions in the credit markets. Historically, our banks primarily obtained funds through deposits by households and enterprises.[4] In recent

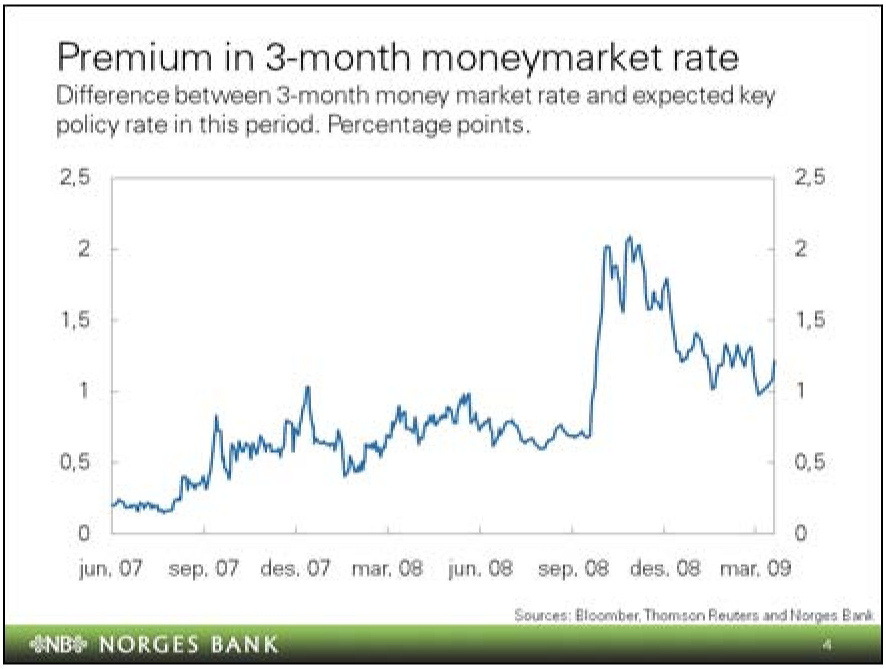
1 Folketrygdfondet will manage the new Government Bond Fund.

2 The Government has increased the capital of Kommunalbanken Norway (the local government funding agency), it has increased the scope of GIEK (the central government export credit agency) and Innovation Norway, and has offered state loans to Eksportfinans Norway (the credit institution for export financing).

3 Figures for banks' equity capital before 1918 are based on: Jan Tore Klovland (2007): "A reconstruction of the balance sheets of savings banks in Norway 1822-1875" and "A reconstruction of the balance sheets of commercial banks in Norway1848-1900" in Øyvind Eitrheim, Jan Tore Klovland and Jan F. Qvigstad (Ed.) (2007): "Historical Monetary Statistics for Norway – Part II" Norges Bank's Occasional Papers, No. 38, Oslo. Statistics Norway is the source for figures from 1919 to 1995. Norges Bank is the source for figures from 1996.

4 Figures are taken from the sources in footnote 3 and Hege Imset Matre, H. I. (1992): Norske forretningsbanker 1848-1990: En tilbakeføring av forretningsstatistikken (Norwegian commercial banks 1848-1990). Report No 41 from the research programme Det nye pengesamfunnet.

years, banks have borrowed in both domestic and foreign markets. When credit markets dried up, this proved to involve high liquidity risk for banks.

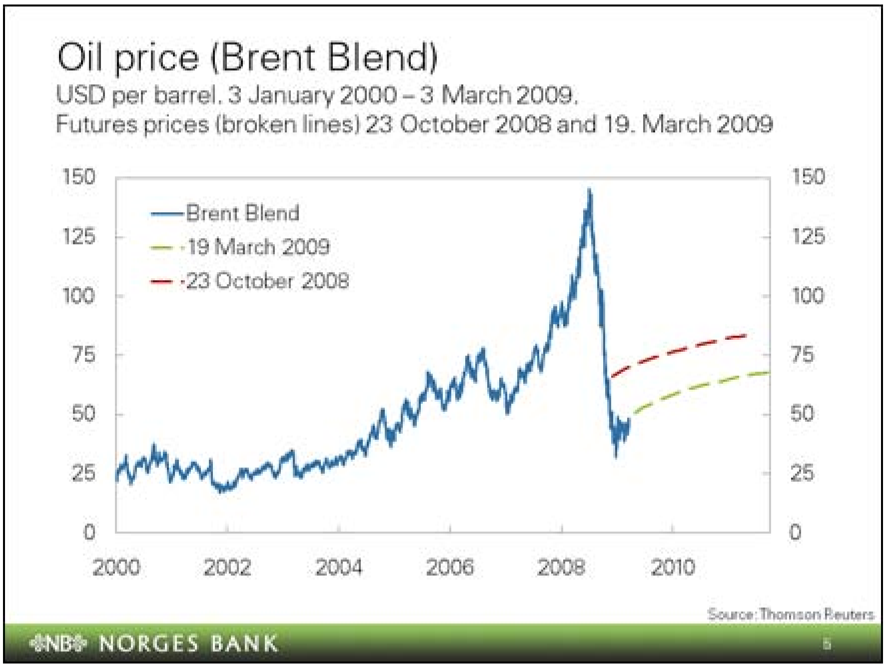


To facilitate the funding of banks operating in Norway, a swap arrangement was established allowing banks to exchange covered bonds for government securities for up to NOK 350 billion. A number of banks have made use of this facility, so far in an amount totaling NOK 80 billion. The arrangement provides banks with Treasury bills. Banks have used these as collateral for loans, sold them or kept them as liquidity reserves.

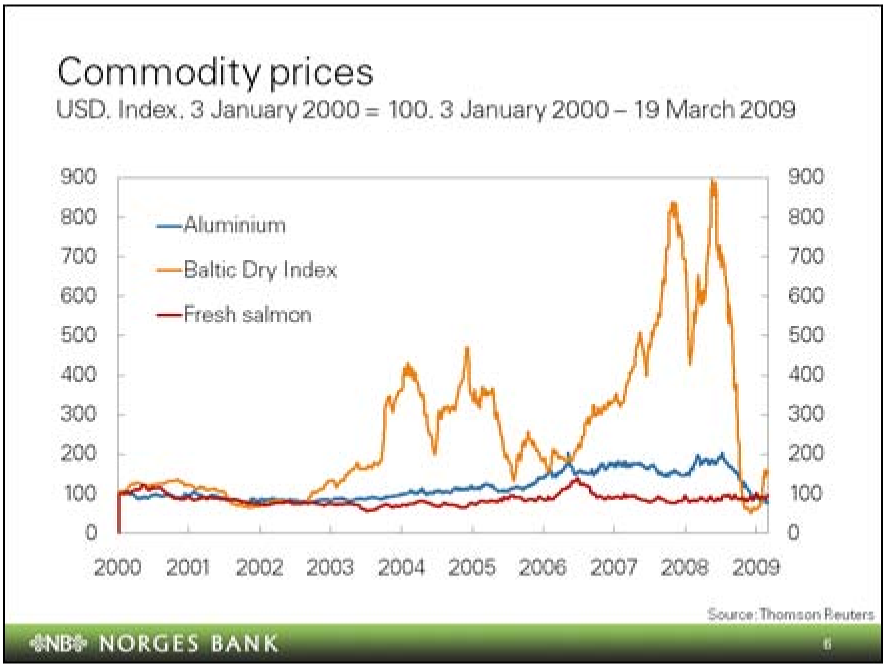
Norges Bank has also expanded its use of its ordinary instruments. We have supplied additional liquidity through our loan facilities and made arrangements for banks to furnish a greater range of securities as collateral for the loans. We have also provided loans with longer-than-usual maturities. The longest maturities have been two- and three-year loans, which have been geared to small banks.

Norges Bank has also supplied Norwegian kroner through currency swaps and offered USD loans to Norwegian banks. Norges Bank entered into a swap agreement with the Federal Reserve, authorising a loan of up to USD 15 billion.

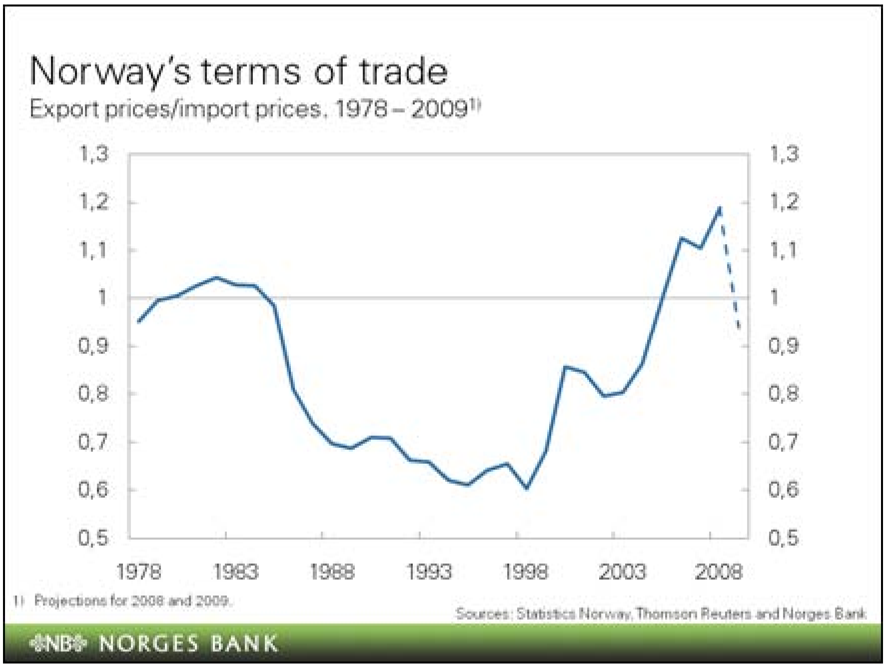
The measures have been effective. Money market rates, which for a period were above 8 per cent, are now approximately 3½ per cent. In this period Norges Bank reduced the key policy rate by 3.75 percentage points to 2 per cent on 25 March. Banks' lending rates have decreased considerably. Credit flows have improved, but access to credit is still difficult for enterprises. Money market premiums have fallen. In the first quarter of 2009, premiums on three-month interest rates in Norway stood at 1.2 percentage points. Norwegian money market premiums are expected to edge down ahead in line with premiums in global markets.



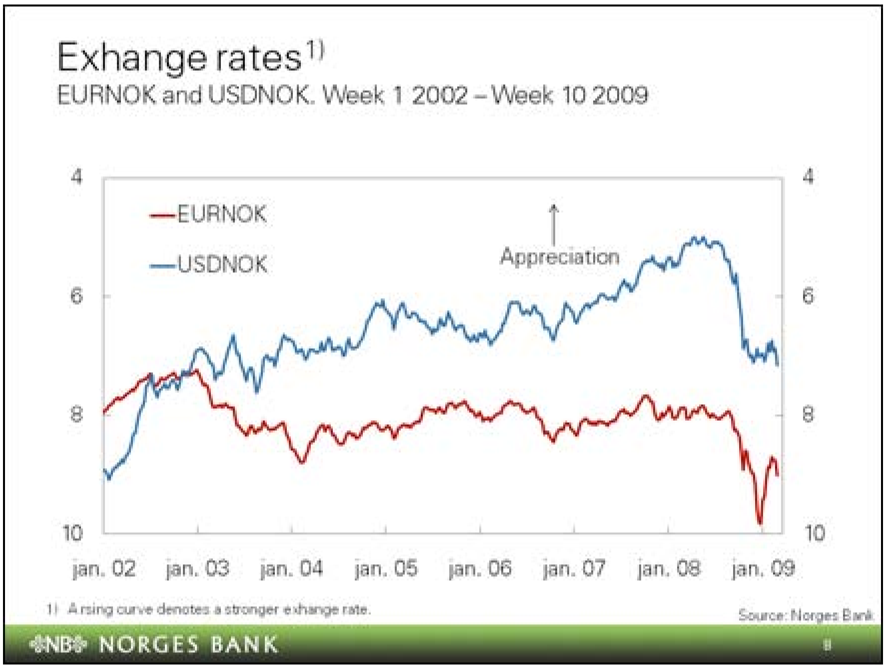
The global downturn led to a marked fall in prices for oil and other commodities through autumn 2008. Oil prices have for a period now hovered around USD 45 per barrel. Oil futures prices have fallen and indicate an oil price of around USD 55 per barrel in 2010.



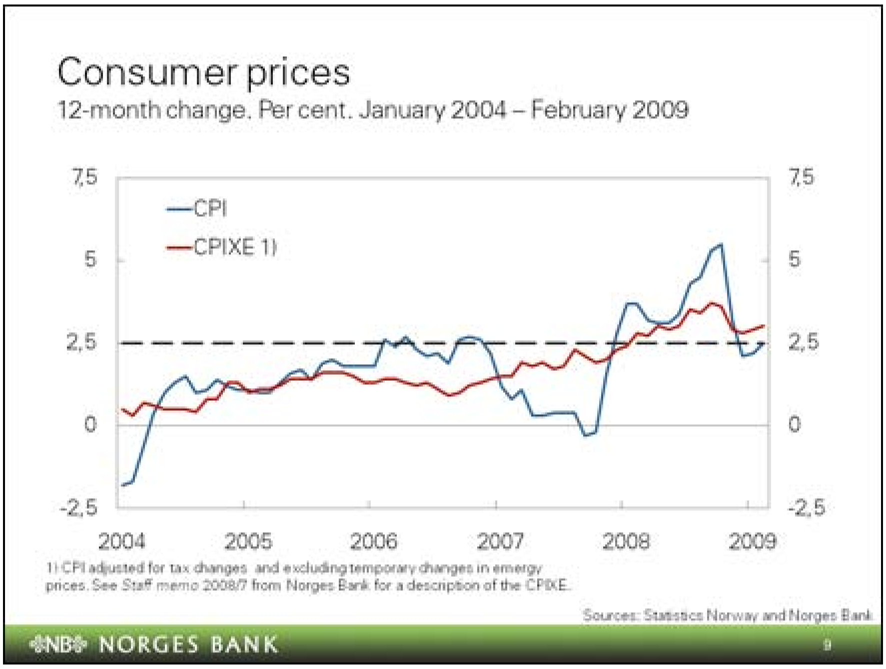
Other commodity prices that are important for the Norwegian economy have also fallen sharply. Metal prices are particularly sensitive to cyclical developments. Futures prices for a selection of raw materials indicate unchanged or moderately rising prices in the next few years. Many countries that have been hit by the economic setback will see an improvement in their terms of trade and growth in their disposable income.



The current downturn followed a period of very high global and domestic economic growth, supported by favorable trading conditions. Few countries benefited more than Norway from the economic upturn, which drove up prices for oil, gas and other export commodities. At the same time, an increasing number of cheap consumer goods were imported from new EU countries and from Asia. Norway's real disposable income increased by more than 40 per cent from 2002 to 2008, more than that of any other western country. But our terms of trade are now deteriorating. Some of the gains of the past few years have dissipated, and our disposable income might fall by close to 10 per cent in 2009.

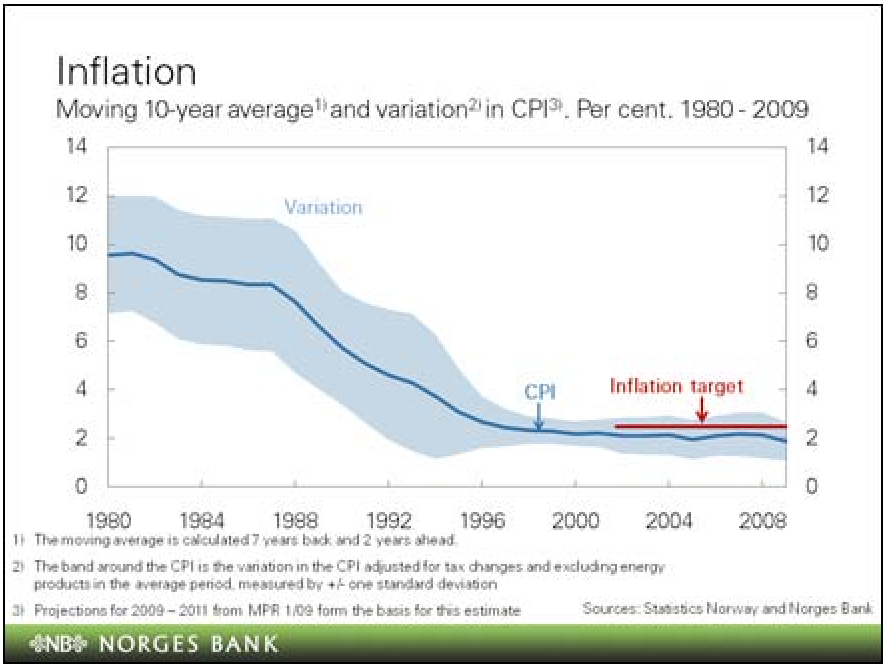


In periods of substantial uncertainty, investors will seek to repatriate investments in foreign currency. The fragility of the Norwegian krone was illustrated when investors fled the currencies of small countries, and the krone weakened considerably. When speculators withdrew, daily fluctuations increased and hedging against exchange rate volatility became more expensive. The krone fell to a record-low level in December last year, but has appreciated since then.



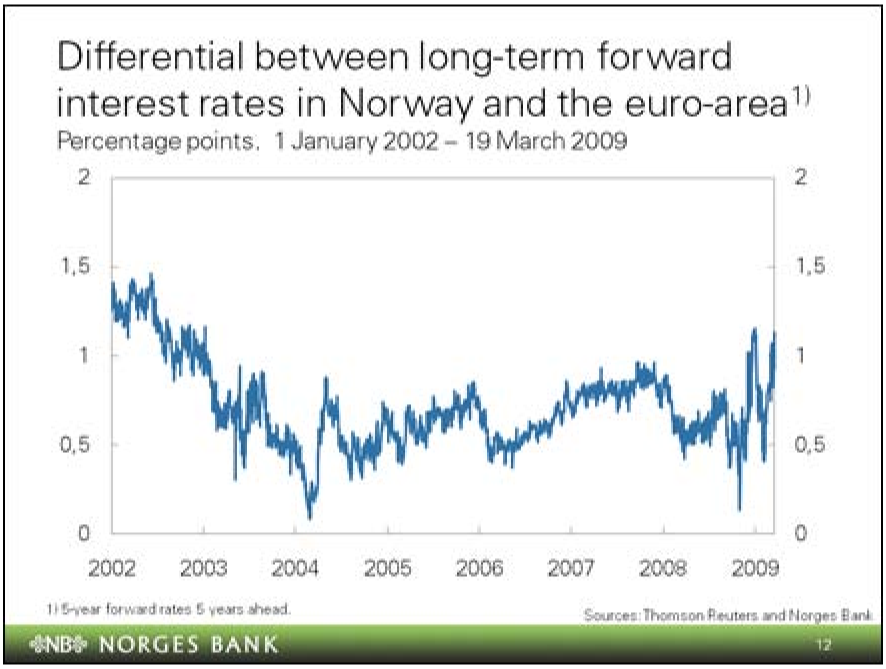
Consumer price inflation reached a peak in October of 2008, and has slowed markedly thereafter and was 2.5 per cent in February. Underlying inflation is still above the inflation target, and stood at approximately 3 per cent in February.

Even though inflation has been falling, the rise in prices has been somewhat sharper than expected recently, particularly for imported consumer goods. The depreciation of the krone last autumn has probably fed through to prices more rapidly than usual. Nevertheless, looking forward inflation will abate.

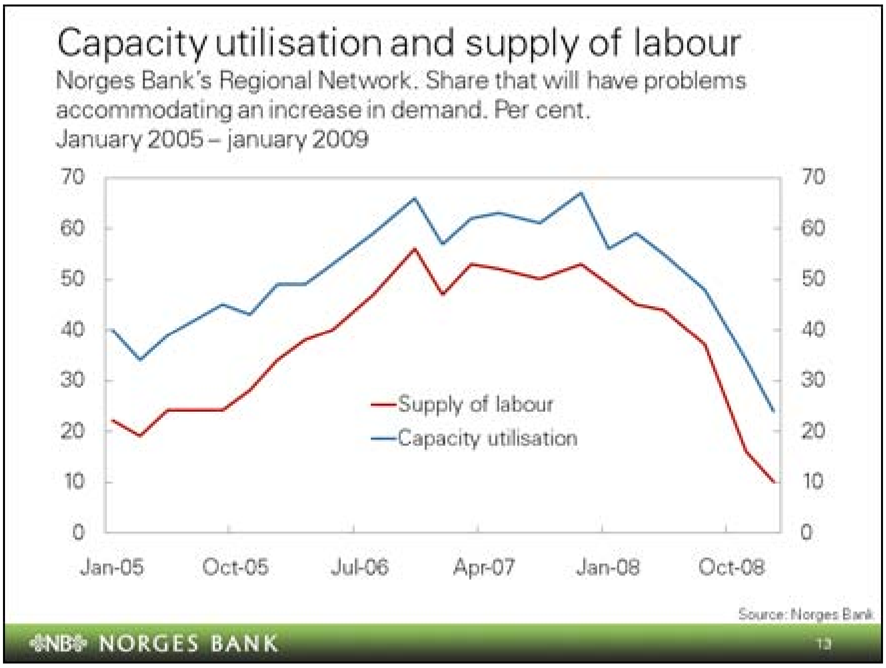


Norges Bank has over a number of years focused on anchoring inflation expectations around the target of close to 2.5 per cent over time and given weight to predictability, with a recognizable response pattern.

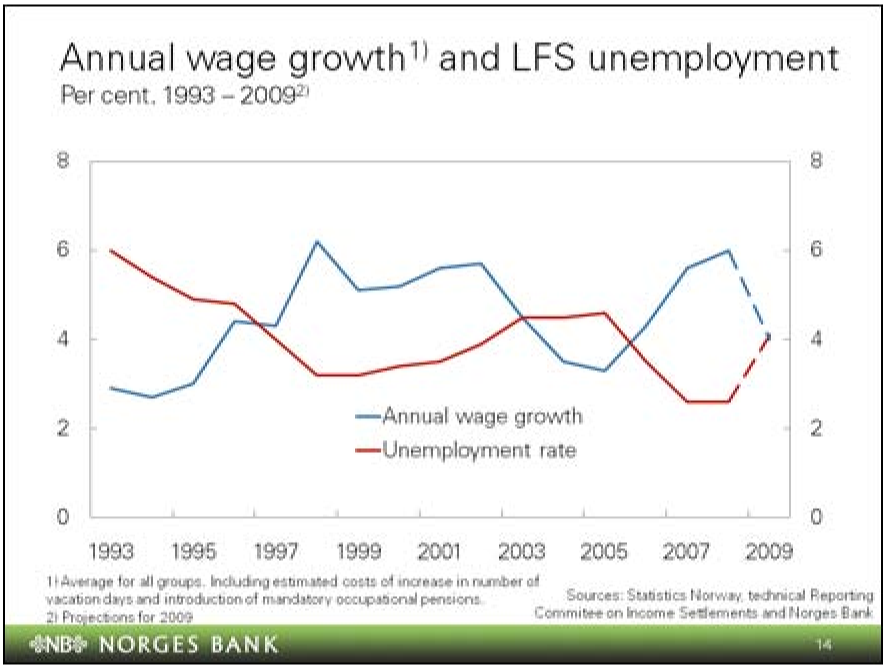
The downturn has not affected long-term inflation expectations to any great extent. According to an expectations survey, inflation expectations five years ahead among experts in the financial industry, the social partners and academia were virtually unchanged from the fourth quarter of 2008 to the first quarter of 2009.



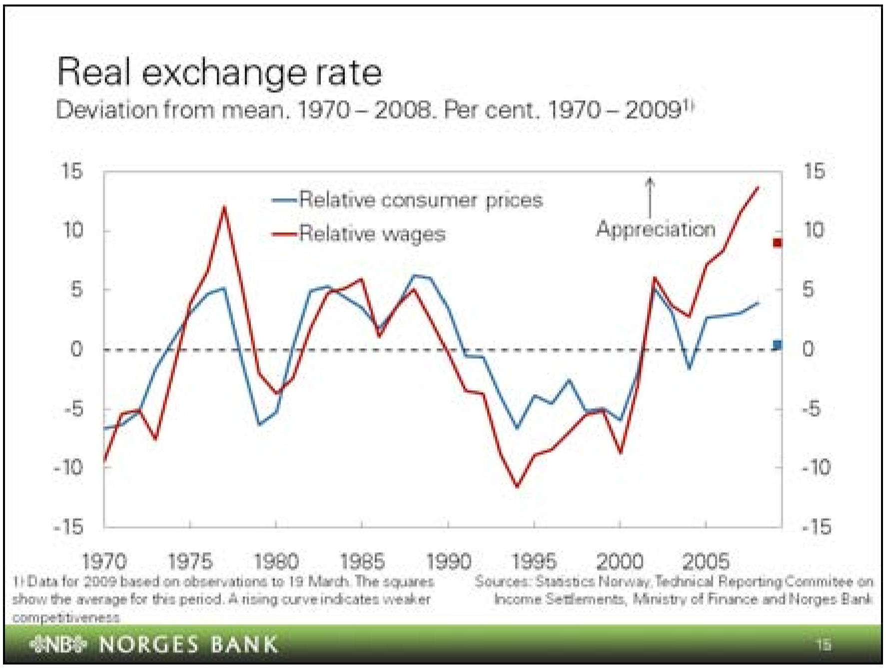
An indicator of inflation expectations in financial markets can be derived from the long-term forward rate differential between Norway and the euro area. Because of a higher inflation target in our country, this differential will normally be around ½-1 percentage point, depending on risk premiums in the bond market. The differential has been in this range in recent years, but has fluctuated somewhat since last autumn.



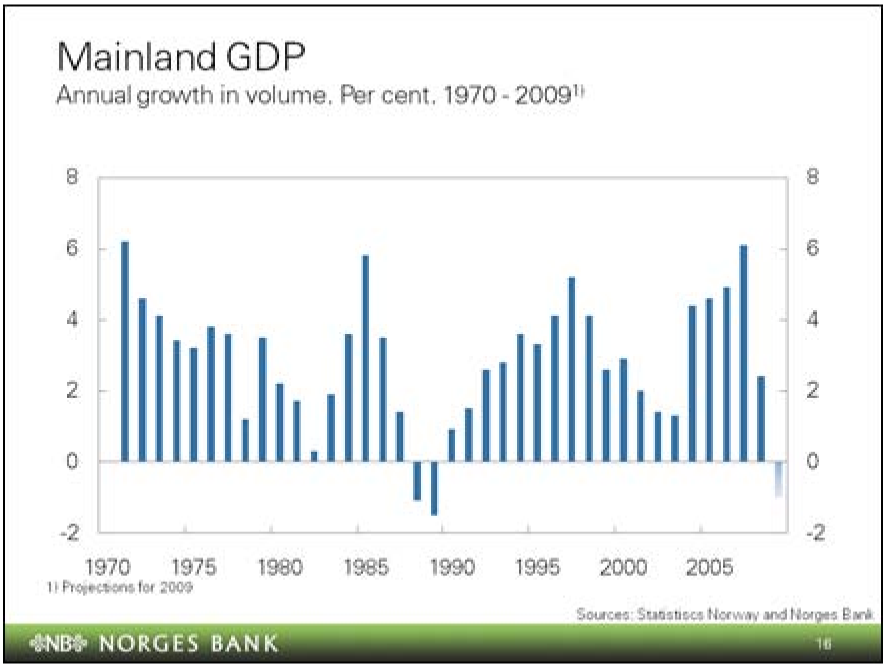
After a prolonged upturn both output and employment are falling in Norway. The turnaround had already occurred just over a year ago, but in the period to autumn last year, it appeared that capacity utilisation would gradually decrease to a normal level. As the global economic outlook deteriorated, it became clear that the slowdown in our economy would occur more rapidly and be more pronounced than envisaged earlier. In November, regional network contacts reported an abrupt and marked turnaround in activity. They now report that the labour supply is no longer a constraint on production. The enterprises in the network are expecting output and employment to fall further over the next six months.



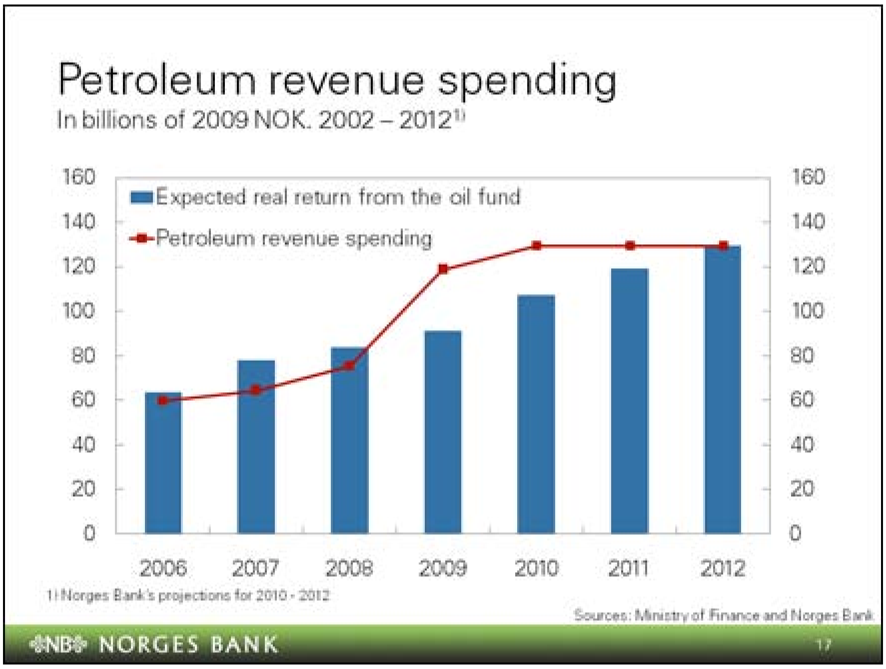
Unemployment has increased since autumn last year, but is still at historical low levels. Unemployment is projected to rise to 4 3/4 per cent at the end of the year. Wage growth is expected to come down this year from a high level in 2008. Lower corporate profitability, rising unemployment and lower consumer price inflation will probably result in low negotiated pay increases this year.



The export sector has been particularly hard hit by the global downturn. Traditional exports have fallen markedly since autumn last year. A contraction in the world economy will result in a substantial decline in Norwegian exports ahead. Moreover, due to the marked fall in commodity prices, export prices are now very low.

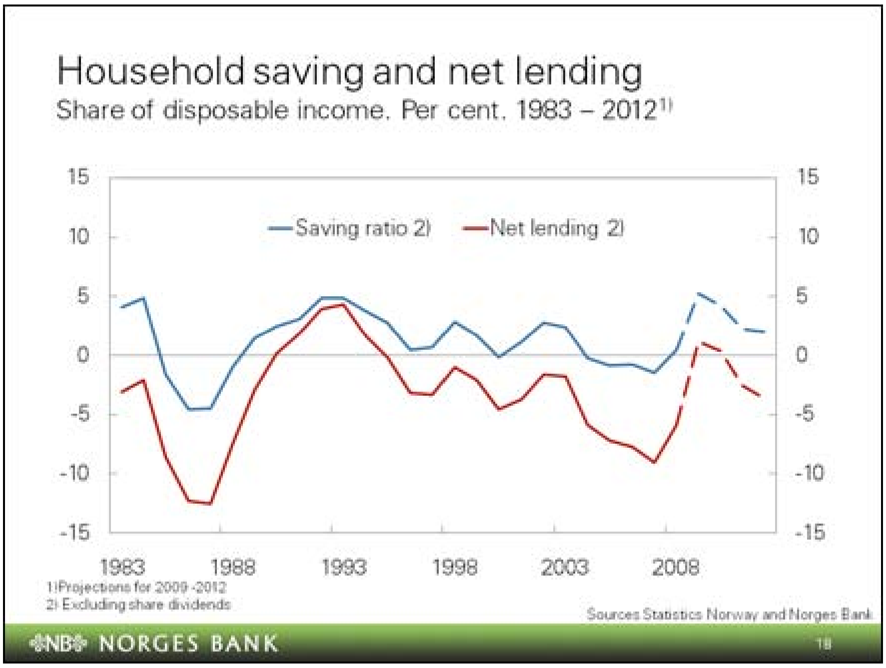


Expensive and reduced access to credit, high interest expenses and uncertainty about developments ahead amplified the downturn towards the end of 2008. Private consumption fell markedly, the decline in housing investment accelerated and mainland business investment started to fall. The downturn in the world economy and the abnormal conditions in financial markets are expected to continue to mark the Norwegian economy ahead. Mainland GDP is projected to contract by 1 per cent between 2008 and 2009.



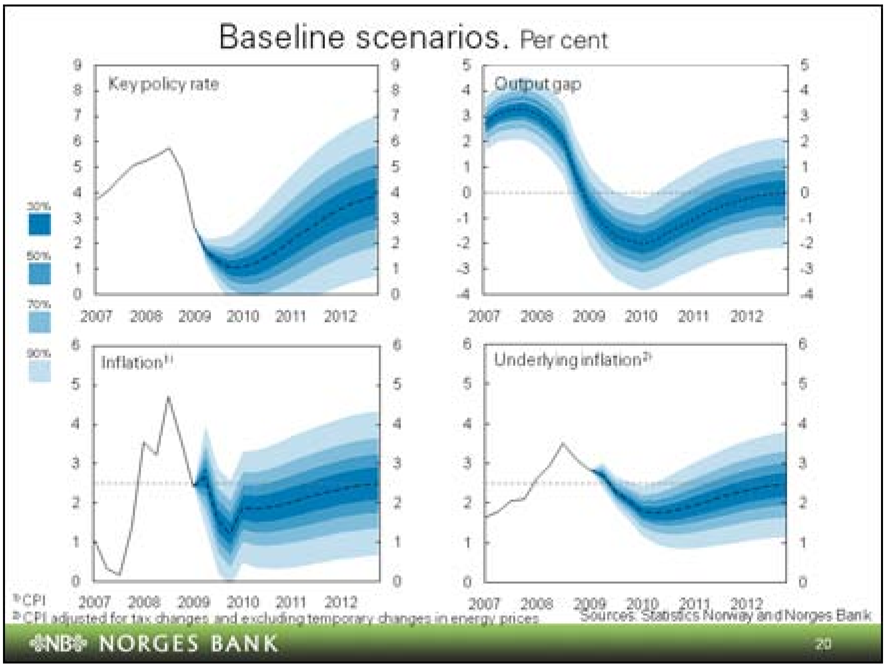
Norwegian government finances are sound with substantial net wealth, although the surplus will be reduced by the fall in oil prices. The automatic stabilisers in the national budget together with discretionary fiscal policy will stimulate the mainland economy by the equivalent of 5 per cent of GDP from 2008 to 2009.

Fiscal policy is assumed to become less expansionary between 2010 and 2012. Government oil revenue spending is expected to be brought back into line with the fiscal rule when cyclical conditions eventually normalise.



We assume that prospects for higher unemployment, a fall in house prices and a high level of debt will induce households to build up financial buffers and reduce debt. The saving ratio is expected to increase considerably. Net lending is projected to be positive this year after being negative since 2004. As household borrowing has been considerable in recent years, deleveraging in the household sector is important to long-term stability in the economy.

The outlook ahead, and monetary policy assessments



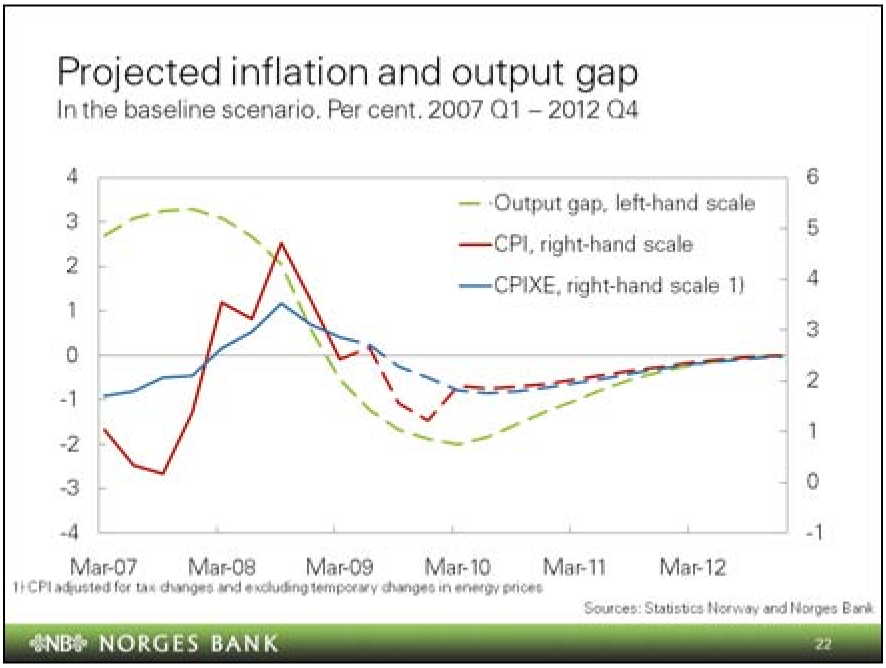
In Norway, inflation will be curbed by lower capacity utilisation. The marked increase in unemployment now envisaged will result in lower pay increases this year and next.

Prospects of weaker growth and lower inflation imply a lower interest rate than presented in the interest rate projection from our last forecast in December. There is also a risk that the global downturn will be deeper and more prolonged than expected. If this proves to be the case, growth in the Norwegian economy will not pick up as quickly and inflation will fall more sharply than we currently assume. The objective of avoiding a pronounced downturn indicates in isolation that the interest rate should be rapidly reduced to a low level.

On the other hand, we have already made substantial reductions in the key policy rate. With a low interest rate, households may save less and the turnaround may occur more rapidly than we assume. This indicates in isolation that changes in the interest rate should be gradual or that further interest rate cuts should be put on hold.

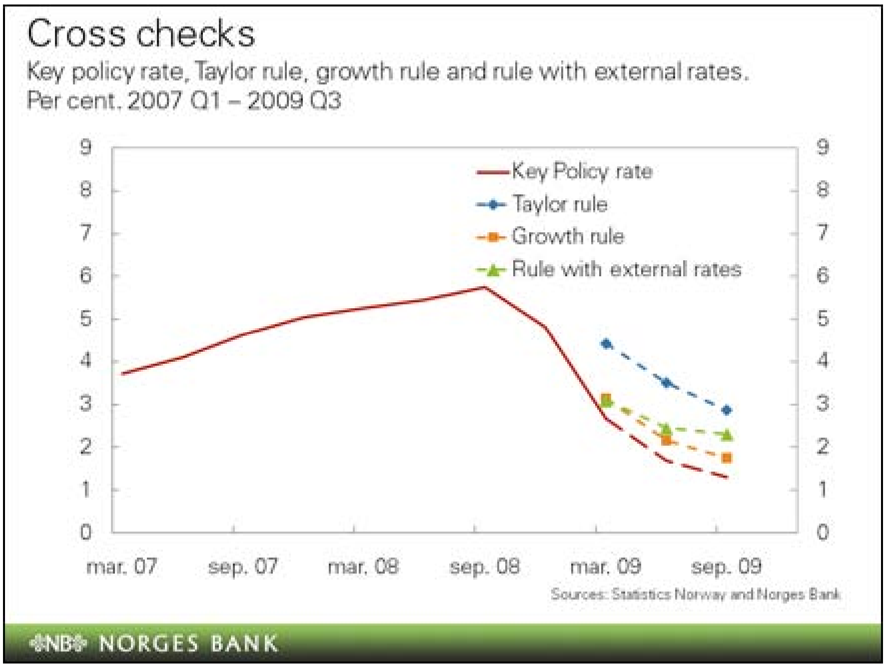
Overall, the outlook and balance of risks suggest that the key policy rate should be gradually reduced further to a level of around 1 per cent in the second half of 2009. This is about one percentage point lower than in Norges Bank's forecast from 17 December last year.

With the low interest rate added to the government fiscal measures, our analysis indicates that growth in the economy will be positive from the second half of this year. Growth will be driven by a rise in private consumption as a result of a low key policy rate, growth in real wages and higher government transfers. Activity in the economy will be underpinned by strong growth in government spending. The projections are based on the assumption that Norges Bank's interest rate changes will translate into lower lending rates for households and businesses. At the same time, tighter credit standards in banks are making monetary policy somewhat less effective than normal.

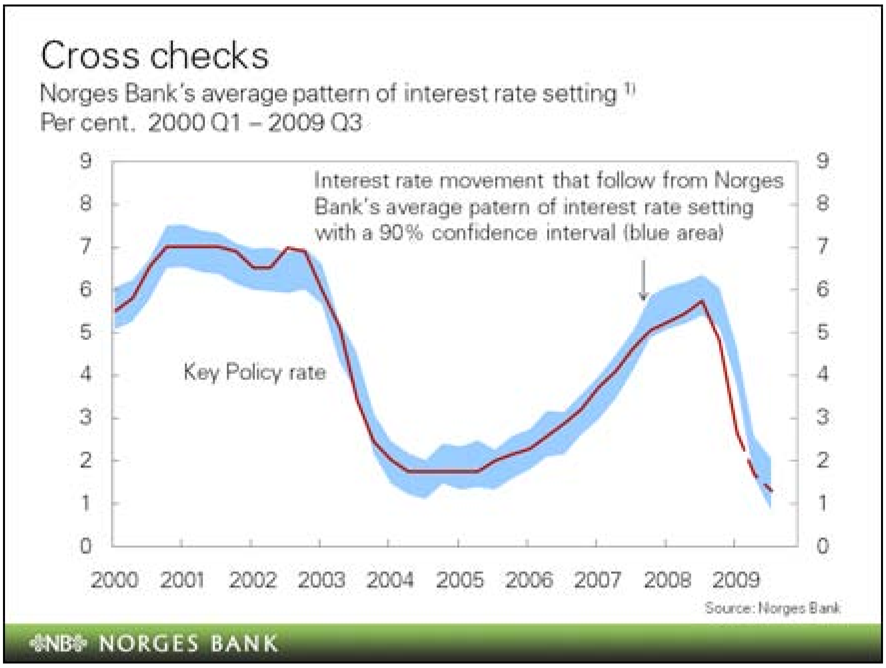


Inflation is projected to fall below 2 per cent in 2010, before gradually moving up towards the target towards the end of the projection period as the output gap gradually closes. There is a risk that the structural changes brought about by the crisis may result in persistently lower productivity growth.

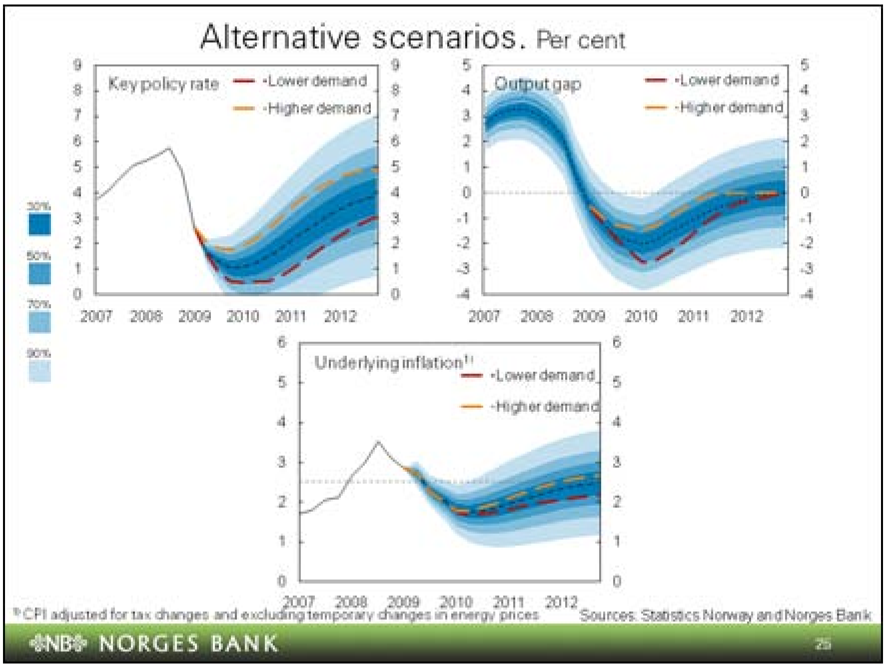
It appears that inflation will remain considerably lower in the years ahead than we expected in December. Both the objective of stabilising inflation around the target and the objective of ensuring stable developments in the real economy suggest that the interest rate should be low.



Interest rate setting can also be assessed using simple monetary policy rules that prescribe an interest rate path based on actual inflation and output. The calculations are based on projections for inflation and output in the current Monetary Policy Report. The different rules yield somewhat divergent results, but all of them indicate a decline in the interest rate. Rules do not capture possible restrictions in the supply of credit that may affect the monetary policy transmission mechanism.



Norges Bank has estimated a simple interest rate rule based on the Bank's previous interest rate setting.[5] The rule includes developments in inflation, wage growth, mainland GDP and central bank key rates abroad. The interest rate in the previous period is also important. The key rate is now below the lower end of the interval projected. Norges Bank has given weight to staving off particularly adverse outcomes and therefore brought forward the decrease in the key policy rate last autumn.



The projections for the key rate, inflation, output and other variables are based on our assessment of the economic situation and our perception of the functioning of the economy and monetary policy. If economic developments are broadly in line with our projections,

5 See Staff Memo 2008/3 from Norges Bank.

economic agents can expect that the interest rate path will also be approximately in line with that projected. On the other hand, the interest rate path may shift if the economic prospects change, or if the effect of interest rate changes on inflation, output and employment differs from that assumed.

In the *Monetary Policy Report,* we present two alternative scenarios where demand is higher or lower than presented in the baseline scenario.

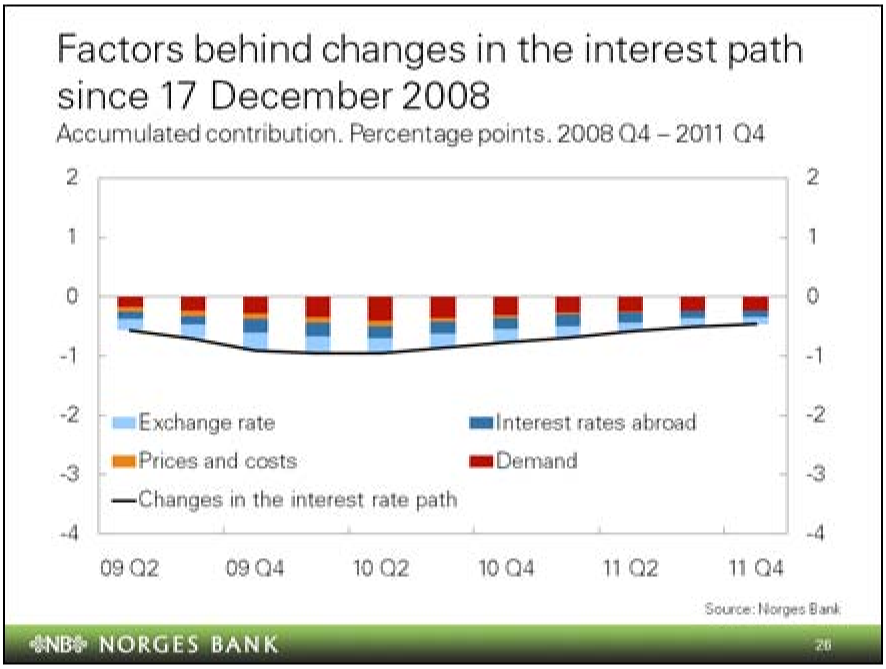
The yellow lines in the chart illustrate a scenario where growth in private consumption is stronger than expected and the turnaround occurs more rapidly. In this scenario, interest rates may decrease to a lesser extent and move up more quickly.

The red lines in the chart illustrate a scenario where the global downturn is deeper and more prolonged, with more pronounced effects than assumed. It will then be appropriate to set a lower interest rate in order to stimulate the economy and thereby prevent inflation from becoming too low.

The primary effect of a key rate close to zero will probably come via a weaker krone. It will then be appropriate to consider instruments other than the interest rate.

Monetary policy normally operates by lowering key rates to reduce the real interest rate when expected inflation and market risk premiums are stable in the short term. When the key rate moves close to its lower bound, the real interest rate can still be influenced through key rate expectations, influencing risk premiums and anchoring inflation expectations. The expectations channel will be particularly important if the current key rate cannot be further reduced.

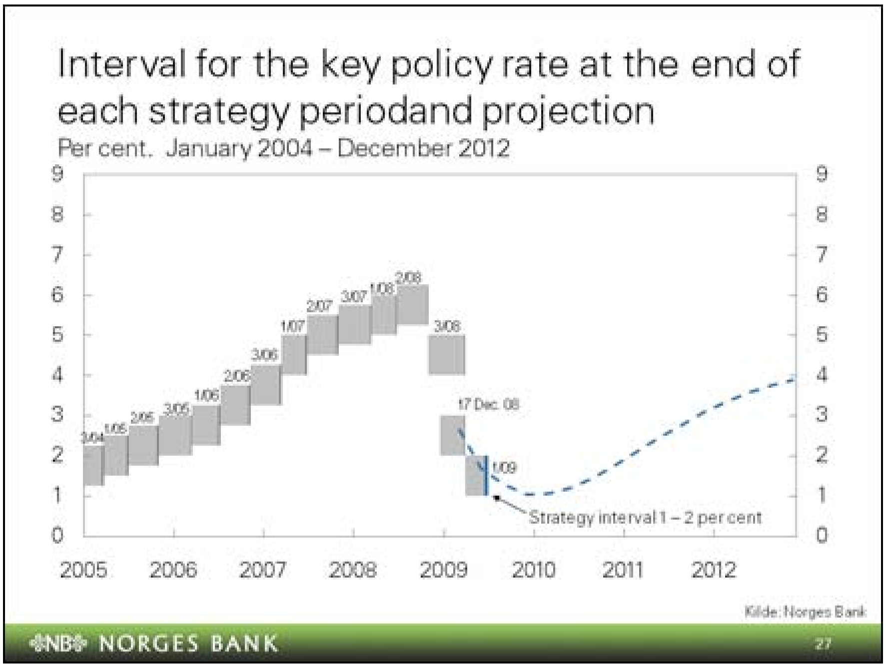
For Norges Bank, the expectations channel is an established part of monetary policy in that we provide forecasts for the key policy rate.



To sum up, it is useful to decompose the factors behind the change in the interest rate path since 17 December 2008. The interest rate forecast in the *Monetary Policy Report* is lower than the forecast published in December last year.

The outlook for global growth has deteriorated further. The slowdown in the Norwegian economy appears to be more pronounced than expected in December. Lower global and domestic demand would suggest a lower key policy rate than projected in December.

Our inflation forecast, along with the stronger krone and lower key rate expectations abroad also suggests a lower key policy rate than projected at that time.



Let me conclude.

Monetary policy cannot fine-tune developments in the economy, but it can mitigate the largest effects when the economy is exposed to shocks. Overall, the outlook and the balance of risks suggest that the key rate should be gradually reduced further. The key policy rate should be in the interval 1-2 per cent in the period to the publication of the next Monetary Policy Report on 17 June 2009, unless the Norwegian economy is exposed to new major shocks.

Thank you for your attention.