Svein Gjedrem: Prospects for the Norwegian economy

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at Sparebank 1 SR-Bank Stavanger, Stavanger, 26 March 2010.

The text below may differ slightly from the actual presentation. The speech is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 24 March and Monetary Policy Report 1/10.

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The most acute phase of the global economic crisis appears to have passed. Output growth has resumed in most parts of the world and the recovery has been strongest in emerging market economies in Asia.

The crisis has given rise to new imbalances that will dampen the recovery.

Fiscal deficits are substantial in many countries and government debt is rising rapidly. Deficits have increased markedly because of reduced tax revenues and stimulus measures to underpin activity, but also due to government support measures for banks. The interest rates at which governments borrow reflect to a large extent their financial position. Reducing government debt in the US and many European countries will probably take several years.

Fiscal tightening is expected to commence among our main trading partners as from next year, with the exception of Sweden. This will curb growth in overall demand for goods and services.

Even with substantial tax cuts, strong growth in public spending and low interest rates, unemployment has risen considerably in both the US and Europe. In many countries, unemployment has grown by 3–4 percentage points. There is a risk that unemployment will become entrenched, perhaps particularly in Europe.

It appears that the upturn in advanced economies will only be moderate. The economies of many countries will continue to be marked by considerable spare output capacity. Spare capacity and high unemployment will contribute to low inflation among trading partners in the coming years.

Oil prices are just below USD 80 per barrel. Our projections are based on an oil price in line futures prices. Futures prices indicate that oil prices will rise ahead. Emerging market economies are making a growing contribution to global oil demand. These economies are expected to continue to record solid growth. In addition, OPEC is steadily gaining market power because growth in oil supply from non-OPEC countries is gradually stagnating. Oil prices may nevertheless edge down if the recovery in the world economy loses momentum, particularly since OECD oil stocks are still at elevated levels and OPEC spare production capacity is relatively high. Gas prices are under pressure owing to increased availability of shale gas in the US, a higher supply of LNG and low demand in Europe.

Futures prices indicate some rise in other commodity prices. Metal prices have risen as a result of improved global growth prospects, but they are still somewhat lower than in summer 2008.

Key rates are close to zero in many countries. A number of central banks have signalled that key rates will be kept low for an extended period, and key rate expectations abroad fell through autumn and winter. Market participants do not anticipate a rise in key rates in the US, the euro area and the UK until the end of 2010.

The interest rate differential between Norway and trading partners has increased. The krone exchange rate has remained fairly stable through winter, although it is somewhat stronger than projected in October. The krone is expected to remain at about the current level to the end of the third quarter and then gradually depreciate somewhat thereafter.

Growth in the Norwegian economy came to a halt in autumn 2008, and Norway entered a downturn in early 2009. The decline appears to have ended in the second quarter of 2009. Capacity utilisation is lower than normal, but the downturn seems to be relatively mild. Activity has been underpinned by substantial interest rate cuts combined with higher public spending and high oil investment.

Fiscal policy was very expansionary in 2009. Petroleum revenue spending increased sharply, and by close to 3 per cent of mainland GDP. Revenue spending will rise further this year. Our projections are based on information from the final budget and the projections in the National Budget for 2010. In line with this, the level of the structural, non-oil budget deficit is maintained at this level to the end of the projection period.

According to the fiscal rule, the fiscal deficit should be reduced to about 4 per cent of the capital in the Government Pension Fund Global (GPFG) when the economy resumes a normal level of activity. If economic developments are broadly in line with projections, a fiscal stance in line with the fiscal rule could result in a lower interest rate and a weaker krone than projected.

The Government has estimated that the annual return on the fund will be around 4 per cent over time. The average real return since the management of the fund began is now 2.7 per cent, up from just 1 per cent a year ago. The figure reflects the recent recovery from the sharpest deterioration in capital markets since World War II. With an unchanged risk profile, the average return will most probably move back towards 4 per cent after a period.

The investment strategy of the fund is built on its long-term investment horizon and substantial size. In 2009, we benefited from the long-term investment horizon. The return on the fund was 25.6 per cent in 2009, which is the highest return ever recorded. The fund's long-term investment horizon enabled it to buy equities and maintain its positions in corporate bonds when other investors were forced to sell assets at low prices during the financial crisis.

In June 2007, the Ministry of Finance decided to increase the allocation to equities from 40 to 60 per cent. This was achieved over the two following years when equities for more than NOK 1 trillion were purchased. The long period of phasing in purchases was profitable as the fund was able to exploit falling equity prices during the financial crisis. The fund's global equity holdings doubled in the same period.

Petroleum investment has increased substantially in recent years. Investment increased between 2008 and 2009 in spite of postponements and cancellations of a number of projects after the financial crisis unfolded in autumn 2008. This reflects that investment projects in 2009 were to a large extent determined by contracts that were concluded prior to the financial crisis. Petroleum investment still showed a substantial decline through 2009.

The volume of petroleum investment is expected to drop further this year and next, followed by a pick-up in 2012 and 2013. The investment decline this year and next reflects postponements of projects and the near completion of large investment projects.

Exports have picked up after world trade showed a faster and somewhat stronger increase than expected. Export companies in our regional network report that new orders have increased and that production is expected to rise over the next six months. A further increase in world trade will contribute to underpinning growth in exports.

Measured by relative labour costs, Norwegian labour has never been as costly as it is now. As a result, the Norwegian export industry may lose market shares ahead. There are no prospects of another rise in export prices as sharp as in the 2000s, when Norway's terms of trade improved considerably.

Norges Bank raised the key policy rate on two occasions by a total of 0.50 percentage point in the fourth quarter of 2009. The feed-through to bank lending rates has so far been somewhat smaller. The average private lending rate increased by 0.09 percentage point from the third to the fourth quarter, but the December interest rate increase will probably only feed through in 2010. Weighted mortgage lending rates have increased by a quarter percentage point since the key rate was raised for the first time in October.

The fall in business investment seems to be nearing an end. Information from the regional network indicates that investment in private services will pick up this year. Manufacturing enterprises in the regional network report that investment will fall between 2009 and 2010. Corporate credit growth is still on the decline, but Norges Bank's fourth-quarter survey of bank lending showed that banks have eased credit standards for the corporate sector. Commercial building starts have picked up slightly since summer.

Housing investment fell sharply between 2007 and 2009. Turnover of new homes has increased and house prices have risen markedly. Housing starts are expected to increase ahead. Household credit growth has been stable in recent months.

Growth in private consumption increased through 2009 and growth is expected to continue. In spite of a lower interest rate level, the household saving ratio increased to a record-high level in 2009. This probably reflected high household debt levels with a need for some households to consolidate, and a large degree of uncertainty owing to prospects of higher unemployment and a fall in the value of housing wealth. At the same time, household real disposable income increased. Almost half the increase is attributable to a lower interest rate level.

Debt burdens are still high, but the stabilisation of employment at a relatively low level has contributed to reducing uncertainty. The interest rate level remains low. In addition, house prices have increased. The saving ratio is therefore expected to fall, and growth in private consumption is projected at 5 per cent in 2010.

Reports from Norges Bank's regional network in February suggested that output growth will remain relatively weak in the coming quarters, but with wide variations across industries. Suppliers to the offshore sector expect activity to continue to shrink. The building and construction industry also expects a further fall in output, while reports from household suppliers and exporters suggest and increase in output ahead.

There are still few regional network enterprises reporting that capacity constraints will make it difficult to accommodate higher demand. Since autumn 2009, it seems that capacity utilisation has increase somewhat in coastal regions from the southwest to the north. Many of the industries that are faring well are located in these regions, such as fish farming, fisheries, parts of the metal industry and suppliers of operating services to the oil sector.

Employment stopped falling in the fourth quarter of 2009. Total mainland employment had then declined by about 30 000 since autumn 2008. The fall in employment has been smaller than the decline in output might imply. Productivity has fallen markedly. During the downturn, the number of hours worked has decreased somewhat more than the number employed. According to the Bank's regional network, reduced use of overtime hours, partial lay-offs and reduced working hours among part-timers have resulted in lower average working hours. Moreover, increased sickness absence has made a contribution. Output growth is expected to increase gradually through 2010, while growth in the number of hours worked shows a relatively small increase. As a result, employment will gradually become more consistent with the level of output, and productivity will rise further through 2010. Compared with previous downturns, productivity growth remains weak.

Owing to a fall in labour force participation, labour force figures were lower at the end of 2009 than at the beginning of the year in spite of underlying growth in the working-age population. Some people exit the labour force or choose not to enter the labour force when labour demand falls. Unemployment continued to rise in the latter half of 2009, but at a far slower pace than earlier in the downturn. Registered unemployment is projected to remain at about today's level to the end of the year. The Technical Reporting Committee on Income

Settlements estimates annual wage growth at 4.1 per cent in 2009. We expect wage growth to show a further decline in 2010.

The uncertainty facing exposed industries is still considerable and wage growth among trading partners is low. A reserve of foreign labour and persons who have temporarily exited the labour force, and who may rapidly return, is probably pulling down wage growth. Wage earners' share of income in the mainland economy is at a high level, after rising from 62 per cent in 2005 to 65 per cent in 2009. On the other hand, unemployment will probably level off at a lower level than in previous downturns, and in some sectors of the economy unemployment is still low. Wage growth is expected to move up towards the end of the projection period.

The operational target of monetary policy is low and stable inflation with annual consumer price inflation of close to 2.5 per cent over time. Over the past 10 years, inflation has on average been somewhat below, but close to 2.5 per cent. From 2003 consumer price inflation was consistently somewhat lower than the target and monetary policy was then oriented towards bringing up inflation. In 2007 and 2008, inflation edged up and exceeded the target somewhat. The key policy rate was gradually raised to a more normal level. When the outlook for the Norwegian economy abruptly changed in autumn 2008, inflation was close to target and inflation expectations were firmly anchored. The key policy rate was reduced from autumn 2008 to summer 2009 to prevent inflation from falling too far below target and to mitigate the effects of the global downturn on the Norwegian economy. The interest reduction brought the real interest rate down to a level far below normal. At the same time, households and firms could remain confident that the expansionary monetary stance would not contribute to price and wage spirals in the longer term.

In Norway, various measures of underlying inflation have been close to 2.5 per cent in recent months. Lower wage growth, reduced capacity utilisation and low global inflation have counterbalanced the effects of higher energy prices and the krone depreciation in autumn 2008. Consumer price inflation is expected to fall to somewhat below 2 per cent in 2010 following the krone appreciation over the past year.

The interest rate is set with a view to stabilising inflation close to 2.5 per cent over time and bringing capacity utilisation gradually back to a normal level. Growth in the Norwegian economy is expected to gradually pick up through the remainder of this year and next. Capacity utilisation is expected to be close to a normal level in 2011 and to reach this level in the course of 2012. In our projections, inflation gradually moves up towards 2.5 per cent around the end of the projection period as capacity utilisation reaches a normal level and the effects of the krone appreciation unwind. Wage growth shows a gradual increase. The projections are based on a gradual rise in productivity. Improved productivity will ease cost pressures for firms. The projections are also based on increased scope for firms to strengthen profitability by raising prices.

Activity in the Norwegian economy picked up towards the end of 2009. The interest rate was raised by 0.50 percentage point towards the end of the year with a view to maintaining inflation at 2.5 per cent over time. New information suggests that the recovery in the Norwegian economy is continuing, but that capacity utilisation is probably somewhat lower than anticipated in autumn 2009. Combined with lower interest rates abroad, a stronger krone and lower wage growth suggest that the interest rate forecast should be revised down somewhat in relation to the October Report.

Interest rates in Norway are low. The effect on private consumption of the substantial interest rate cuts in 2008 and 2009 has probably not been exhausted and high consumption growth is expected to continue in 2010. House prices have risen. The new guidelines for prudent residential mortgage lending issued by Finanstilsynet (the Financial Supervisory Authority of Norway) may curb household debt accumulation. Over time, household borrowing may nevertheless increase considerably and saving may fall. The aim of guarding against the risk of future imbalances, which may disturb activity and inflation somewhat further ahead, suggests that the interest rate should be gradually brought closer to a more normal level.

On the other hand, a marked interest rate increase in Norway and a wider interest rate differential between Norway and other countries may entail a risk of a considerably stronger-than-projected krone, resulting in inflation that is too low. This will make it difficult to bring inflation up to target within a reasonable time horizon. A strong krone may also lead to lower activity in exposed industries and thereby lower capacity utilisation in the Norwegian economy. This suggests that the interest rate should not be raised too rapidly.

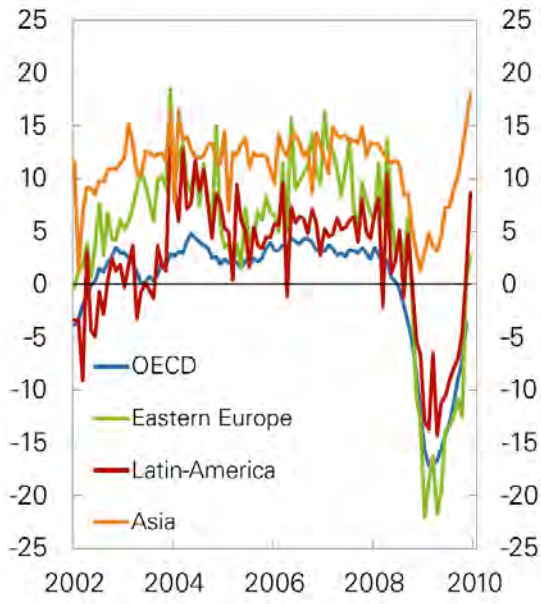
Monetary policy cannot fine-tune developments in the economy, but it can mitigate the most severe effects when the economy is exposed to shocks. Overall, the outlook and the balance of risks suggest that the key rate should be gradually increased ahead, although somewhat later than we envisaged in October 2009.

On 24 March, the Executive Board decided that the key policy rate should be in the interval 1½–2½ per cent in the period to the publication of the next Report on 23 June 2010 unless the Norwegian economy is exposed to new major shocks. The interest rate was kept unchanged at this meeting. This is based on the assessment that inflation and capacity utilisation may for a period be slightly lower than previously projected and that the interest rate should be increased somewhat later than expected in autumn 2009.

Thank you for your attention

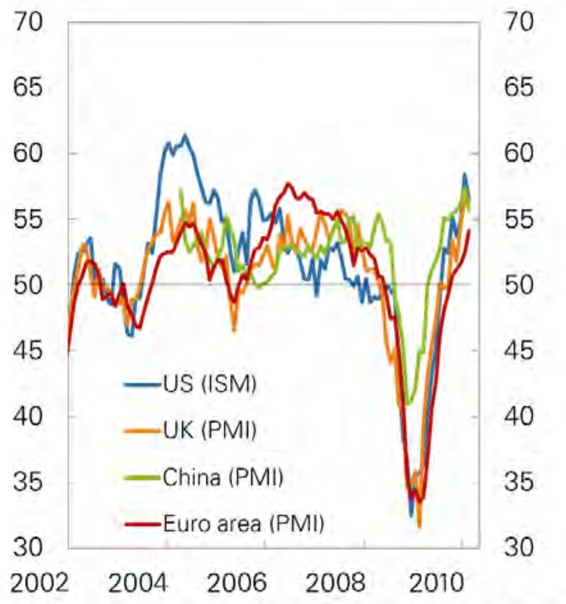
Manufacturing output in OECD and emerging markets

12-month change. Per cent.
January 2002–December 2010



Leading indicators for the manufacturing sector

Diffusion index. Seasonally adjusted.
January 2002–February 2010

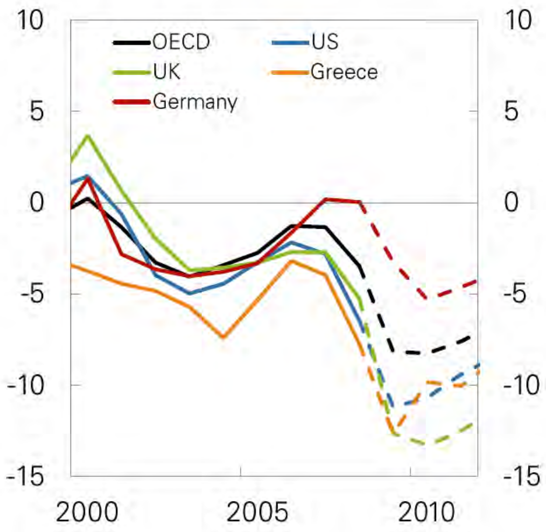


Sources: IMF, Thomson Reuters and Norges Bank

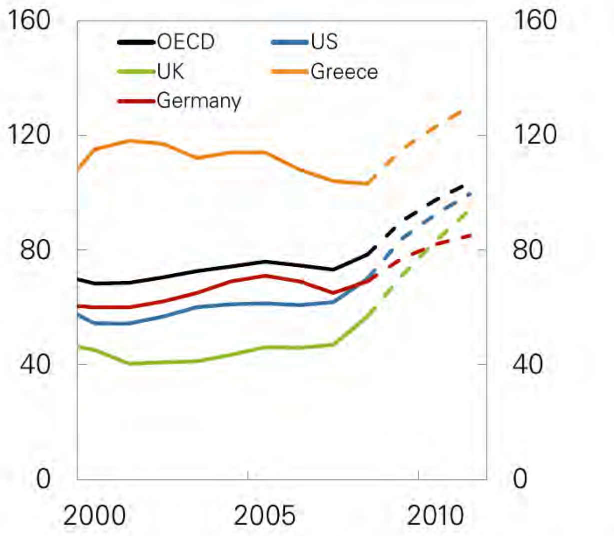
Public finances

2000–2011. Projections for 2009–2011

Fiscal deficit. Percentage of GDP



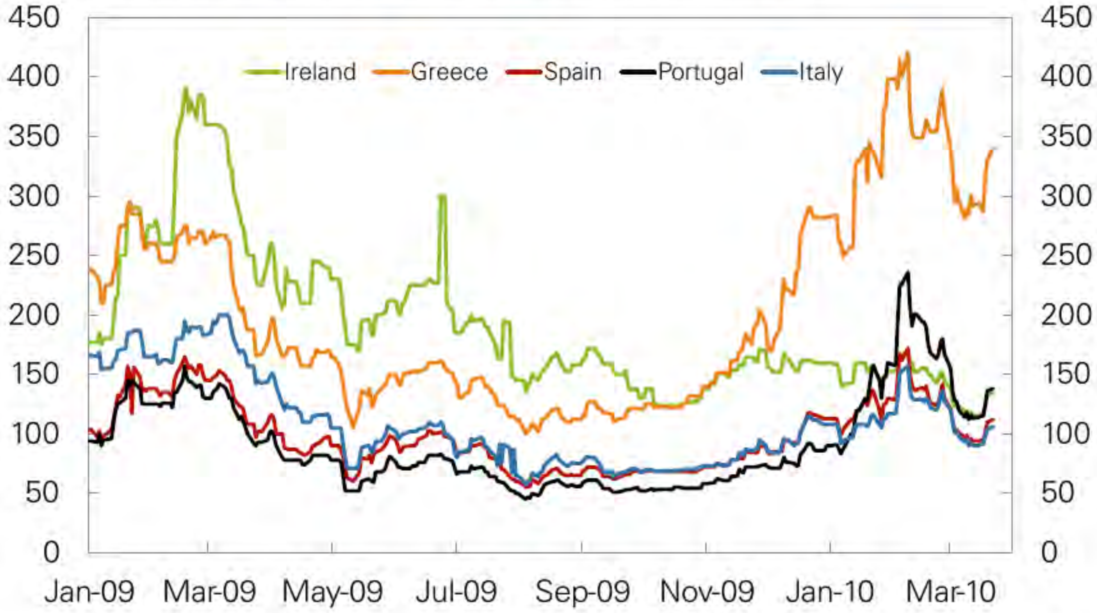
Public gross debt. Percentage of GDP



Source: OECD Economic Outlook 86

CDS prices for GIIPS-countries

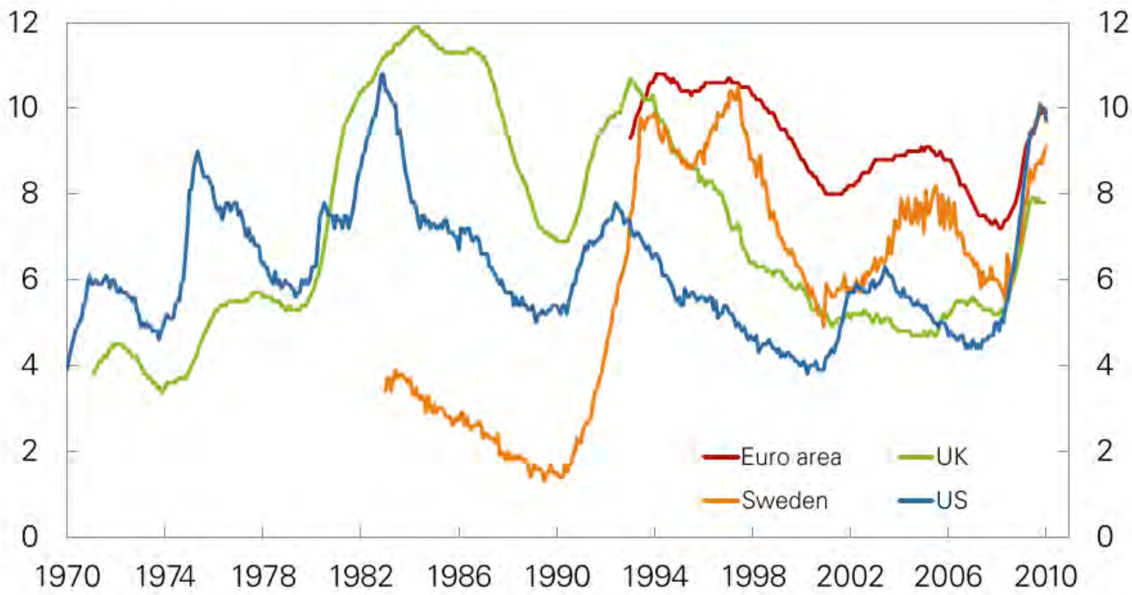
Sovereign bond credit spreads. Measured by CDS prices. 5-year maturity. Basis points. 1 January 2009–22 March 2010



Source: Bloomberg

Unemployment

Share of labour force. Per cent. Seasonally adjusted. January 1970–February 2010



Source: Thomson Reuters

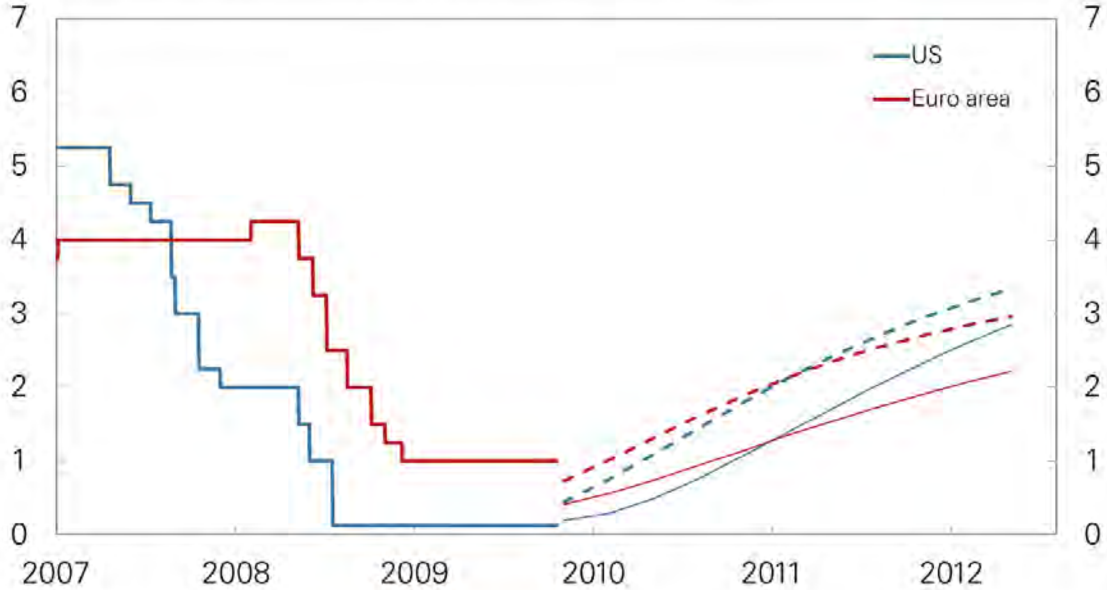
Oil price in USD per barrel

1 January 2002–3 March 2010. Spot and futures prices

Sources: Thomson Reuters and Norges Bank

Actual and expected key rates

Per cent. 1 June 2007 – 31 December 2012[1)]

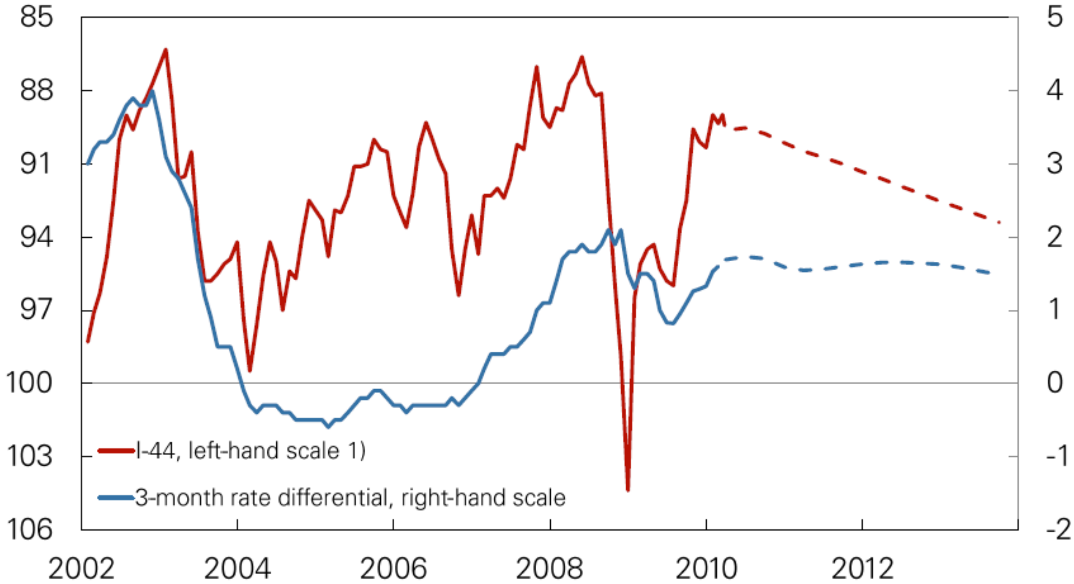


1) As at 18 March 2010 (thin lines) and 28 October 2009 (broken lines)

Sources: Bloomberg, Thomson Reuters and Norges Bank

Interest rate differential and the import-weighted exchange rate index (I-44)

Monthly and quarterly[2] figures. January 2002–December 2013

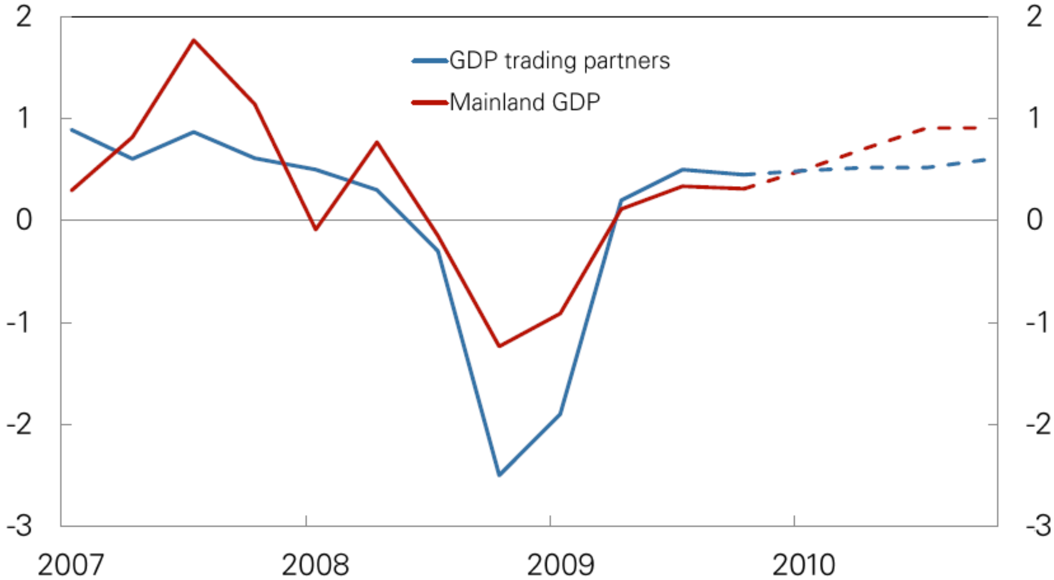


1) A rising curve indicates a stronger krone exchange rate
2) Broken lines show projections from MPR 1/10

Sources: Thomson Reuters and Norges Bank

GDP

Growth on previous quarter. Norway and trading partners. Seasonally adjusted. Per cent. 2007 Q1–2010 Q4[1]

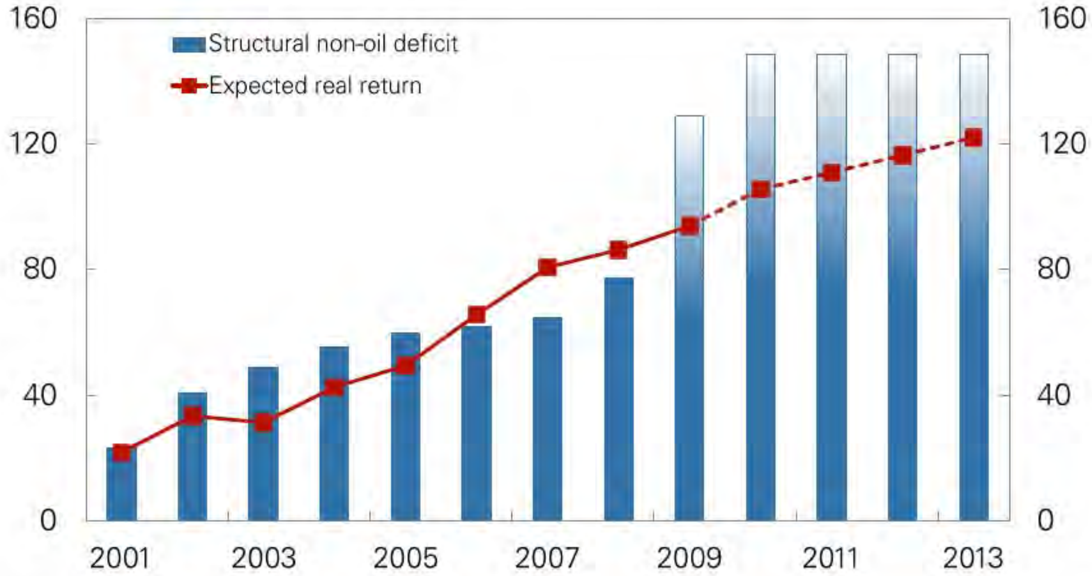


1) Broken lines show projections from MPR 1/10

Sources: Statistics Norway and Norges Bank

Petroleum revenue spending

Structural, non-oil deficit and expected real return on the Government Pension Fund Global. In billions of 2010 NOK. 2007–2013[1)]

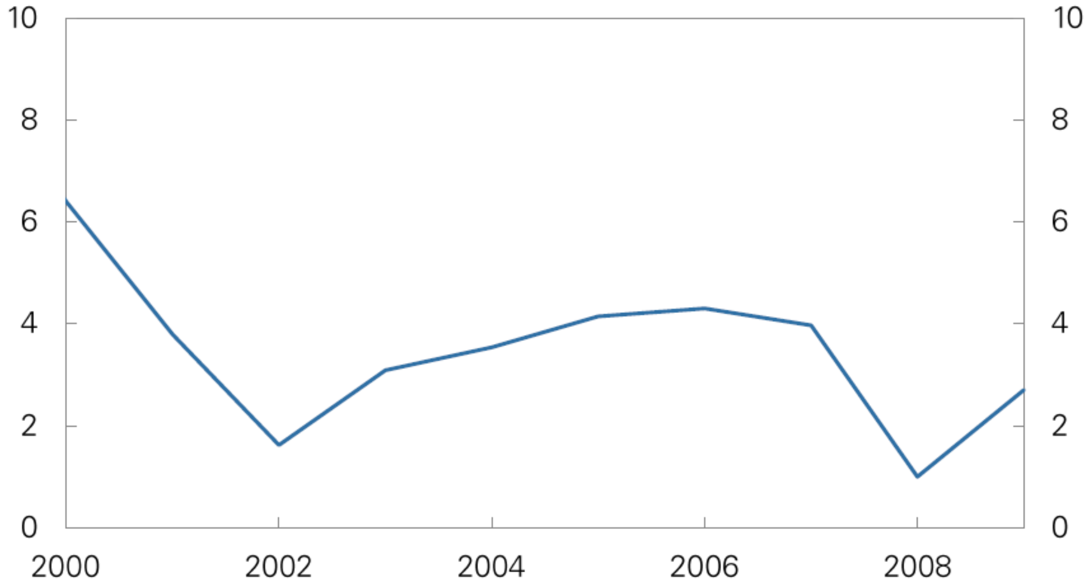


1) Projections from the Ministry of Finance and Norges Bank for 2009/2010 -2013

Sources: Ministry of Finance and Norges Bank

Return on the Government Pension Fund Global

Average real return since 1998. Per cent. 2000–2009

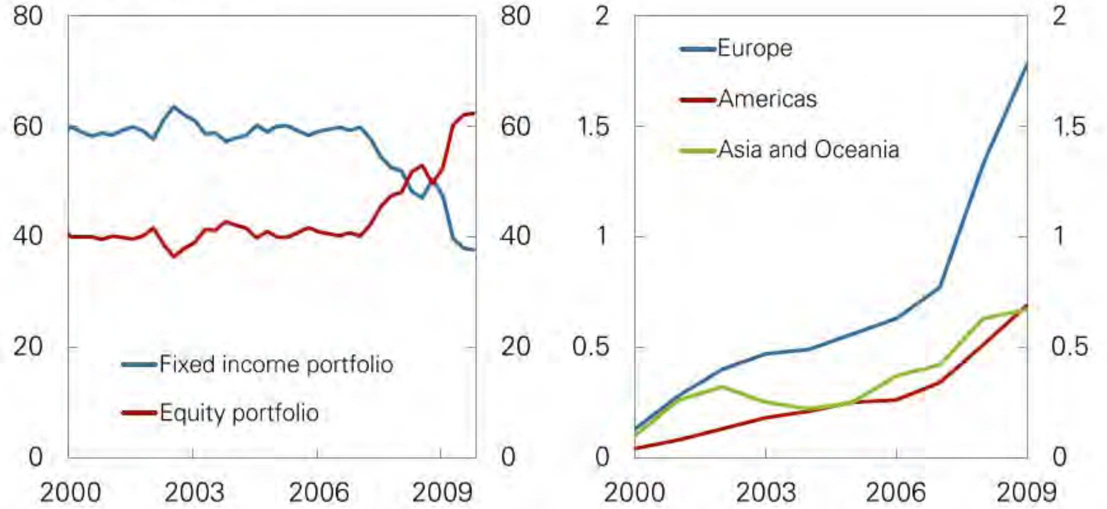


Source: Norges Bank

Holdings in the Government Pension Fund Global

Breakdown by asset classes. As a percentage of the fund. 2000 Q1–2009 Q4

Equity holdings[1]. 2000–2009

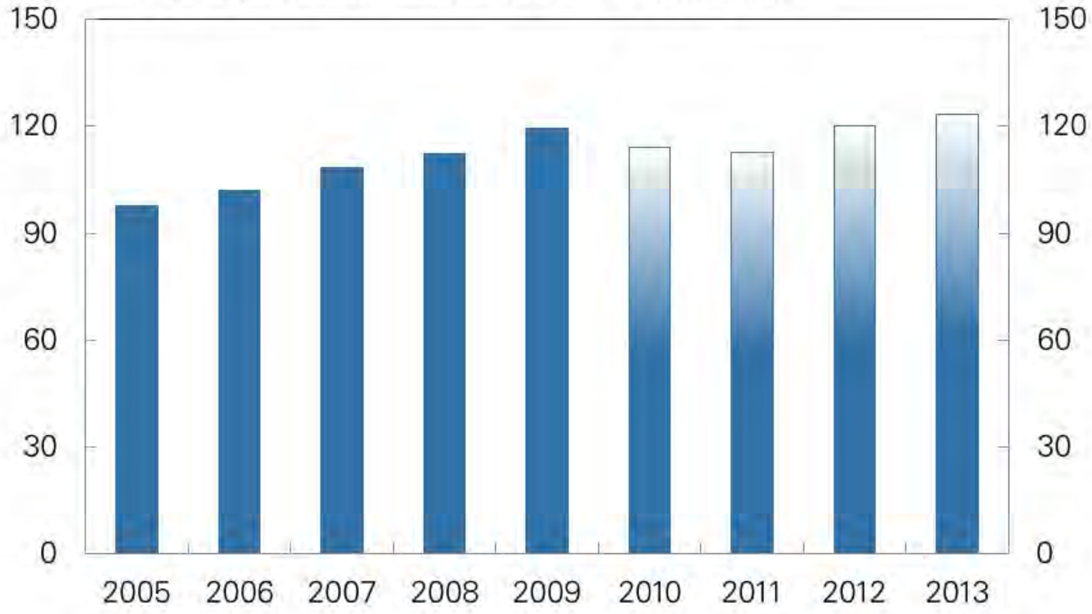


1) As a percentage of FTSE All-World Index's market capitalisation

Sources: FTSE and NBIM

Petroleum investment

Constant 2007 prices. In billions of NOK. 2005–2013[1]

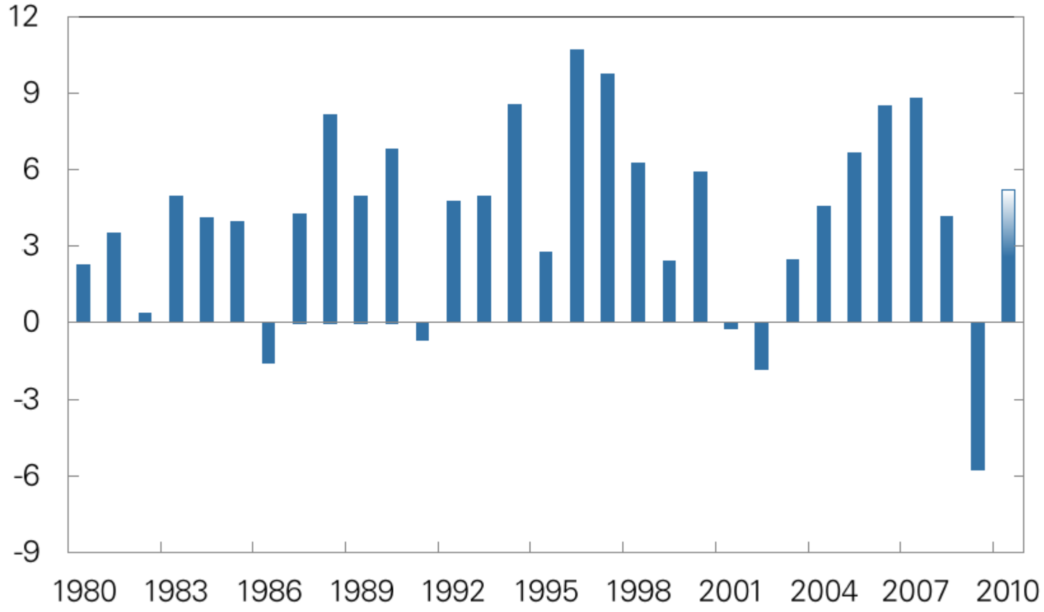


1) Projections for 2010 – 2013

Source: Statistics Norway and Norges Bank

Exports from mainland Norway

Annual change. Volume. Per cent. 1980–2010[1)]



1) Projections for 2010

Source: Statistics Norway and Norges Bank

Real exchange rate

Deviation from mean over the period 1970–2009. Per cent. 1970–2010[1)]

1) The squares show the average so far in 2010. A rising curve indicates weaker cometitiveness

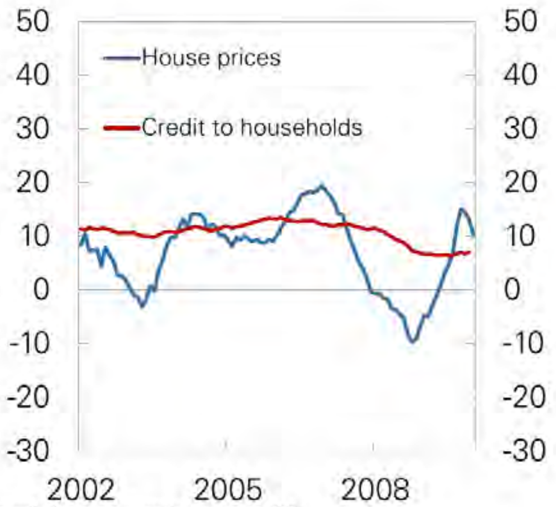
Sources: Statistics Norway, Technical Reporting Committee on Income Settlements, Ministry of Finance and Norges Bank

Key policy rate and lending rates
Daily figures. Per cent 1 June 2007–26 February 2010

1) 3-month NIBOR (effective)
2) Interest rate on new mortgage loans of NOK 1m within 60% of purchase price with variable interest rate. Figures for the 20 largest banks, weighted according to market share
3) Non-financial enterprises. 2007 Q2 2009 Q4

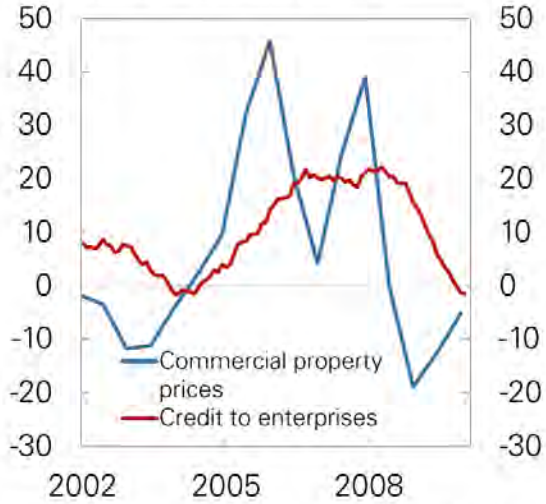
Sources: Norsk familieøkonomi AS, Statistics Norway and Norges Bank

Credit to households[1] and house prices
12-month change. Per cent. January 2002–February 2010[2]



1) Credit from domestic sources, C2
2) House prices for February. Credit growth to end-January
3) Semiannual figures. To end-2009

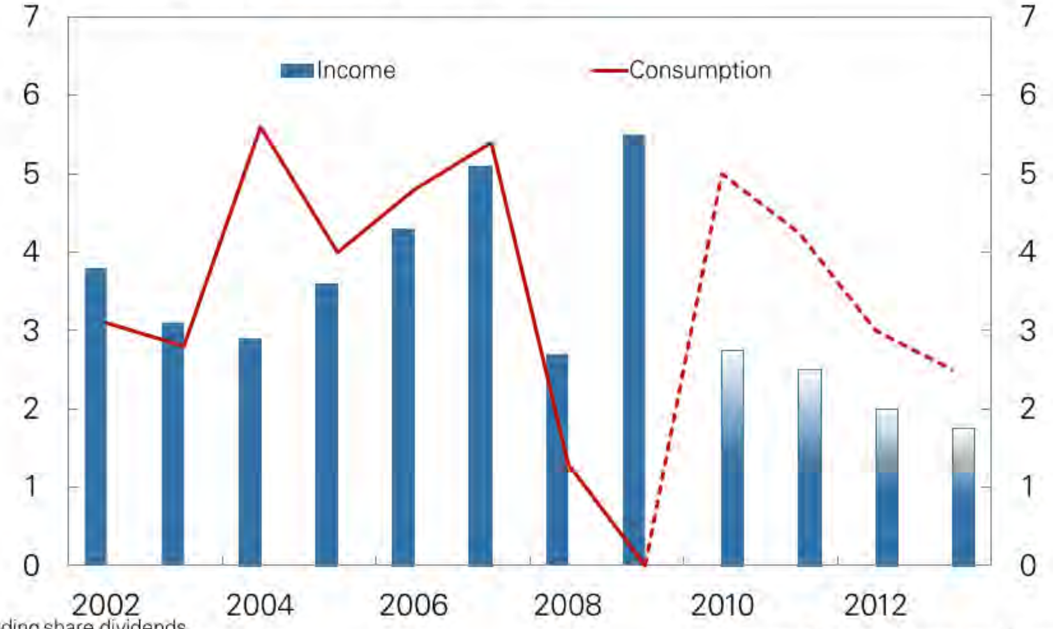
Credit to enterprises[1] and commercial property prices[3]
12-month change. Per cent. January 2002–January 2010



Sources: Statistics Norway, OPAK, the real estate sector (NEF, EFF, FINN.no og ECON Pöyry), OBOS and Norges Bank

Household real disposable income[1] and consumption

Annual change. Per cent. 2002–2013[2]

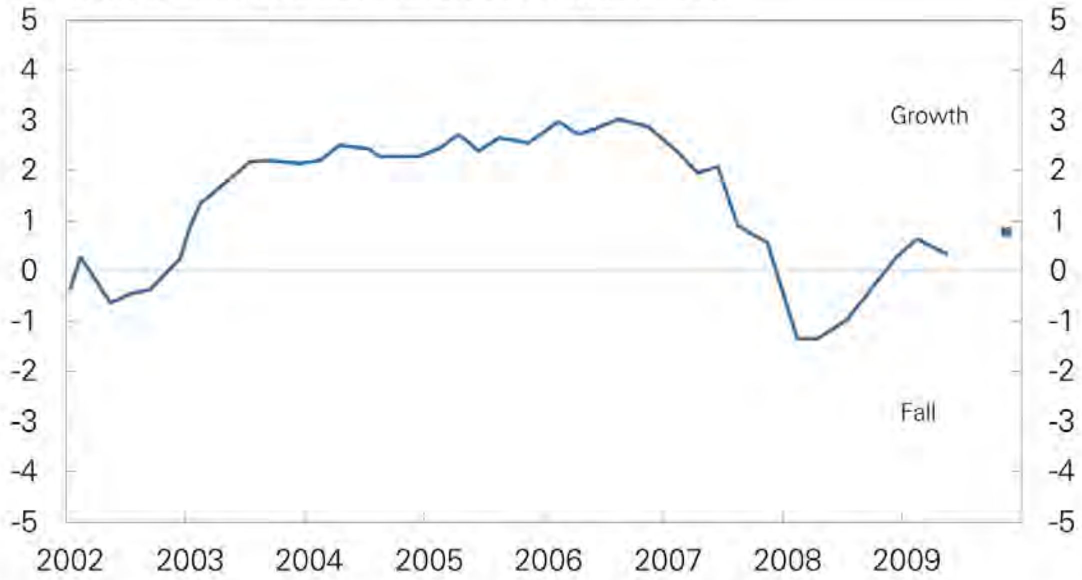


1) Excluding share dividends
2) Projections for 2010 – 2013 from MPR 1/10

Sources: Statistics Norway and Norges Bank

Output

Indicator of actual change past three months and expected change next six months. Index[1]. October 2002–August 2010

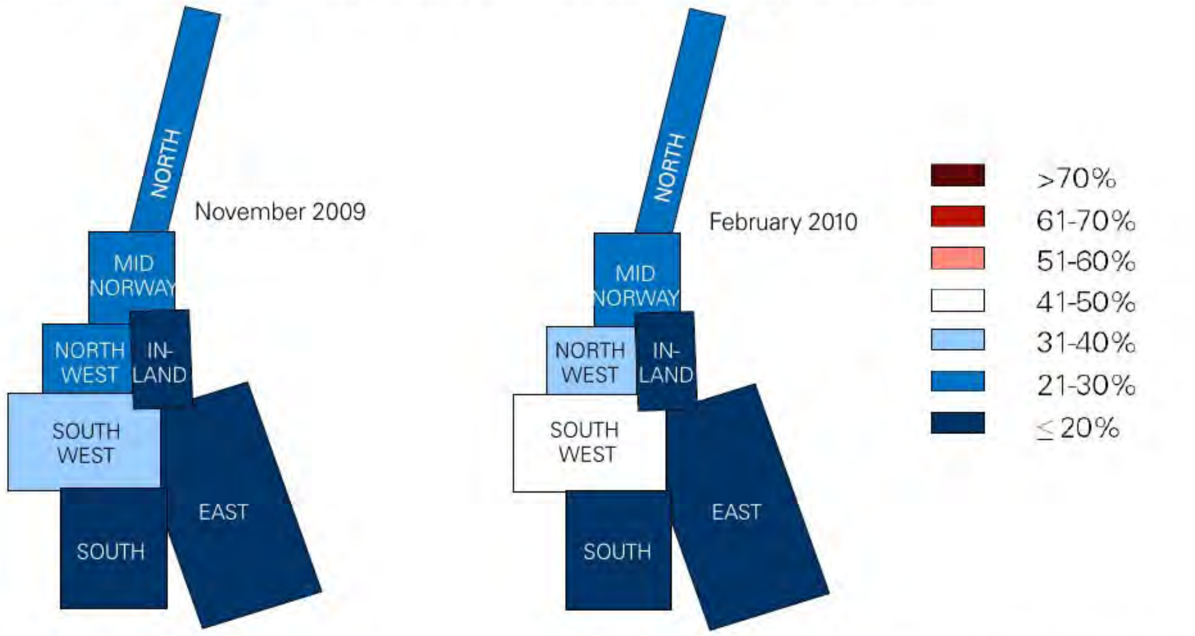


1) The scale runs from -5 to +5, where -5 indicates a sharp fall and +5 indicates strong growth.

Source: Norges Bank's regional network

Capacity utlilisation

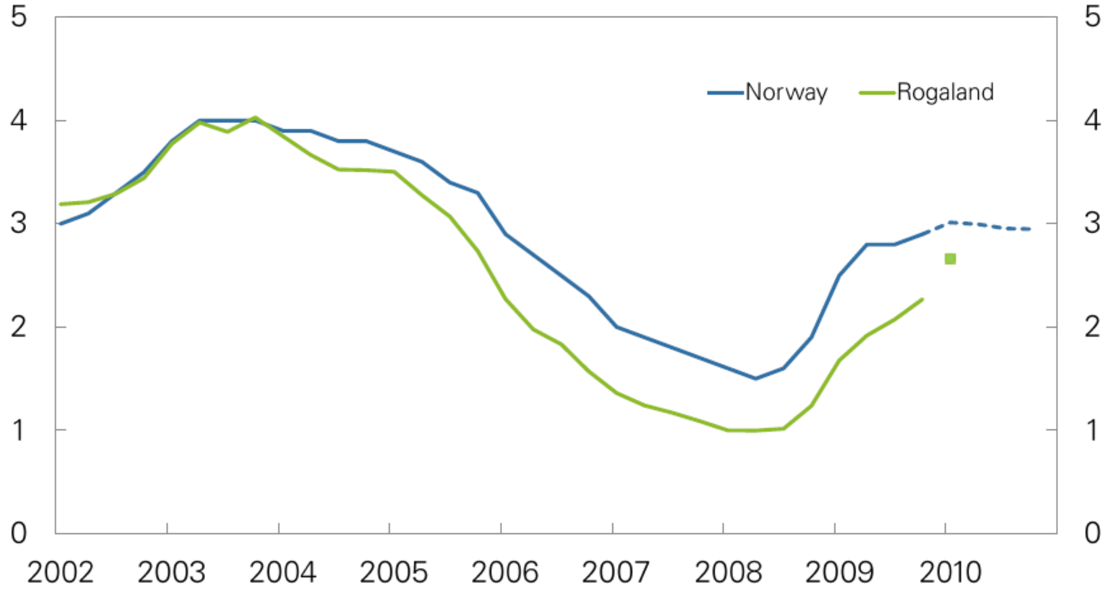
Share that reports some or considerable capacity constraints



Source: Norges Bank's regional network

Registered unemployment

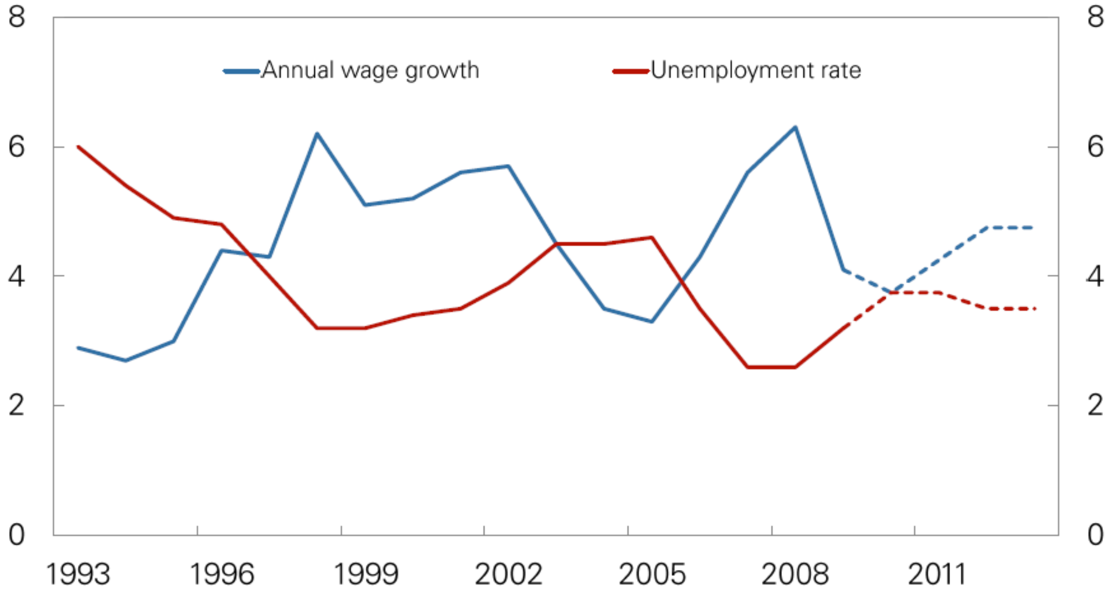
Percentage of the labour force. Seasonally adjusted.
2002 Q1–2010 Q4[1)2)]



1) Broken line shows projections from MPR 1/10
2) Unemployment rate in Rogaland for 2010 Q1 is calculated based on figures for January and February
Sources: Norwegian Labour and Welfare Administration and Norges Bank

Annual wage growth and LFS unemployment

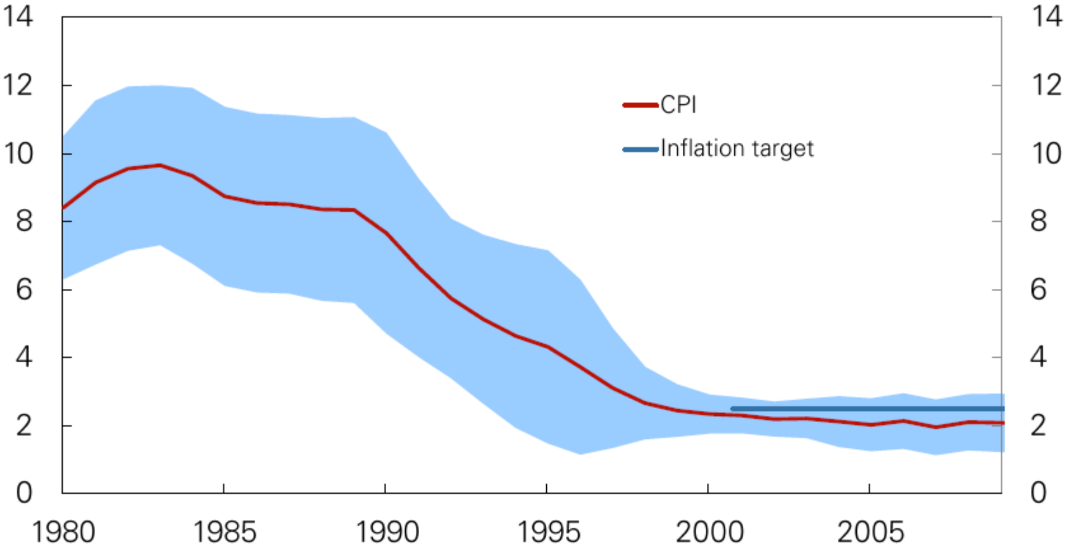
Per cent. 1993–2013[1)]



1) Broken lines show projections from MPR 1/10
Sources: Statistics Norway, Technical Reporting Committee on Income Settlements and Norges Bank

Inflation

Moving 10-year average[1)] and variation[2)] in CPI[3)]. Per cent. 1980–2010

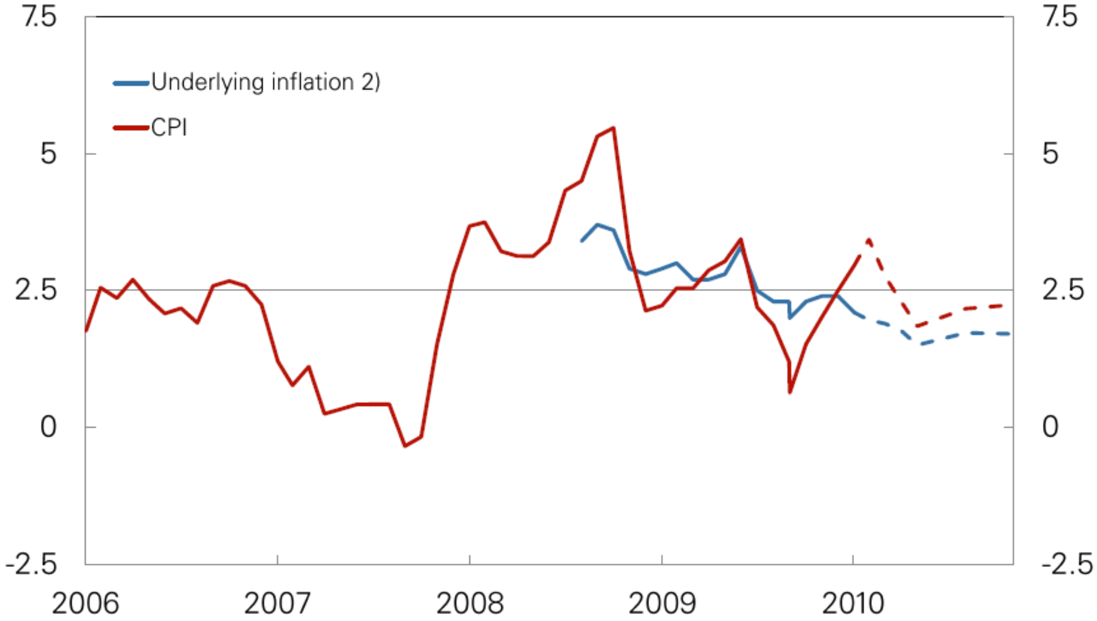


1) The moving average is calculated 10 years back
2) The band around the CPI is the variation in the CPI adjusted for tax changes and excluding energy products in the average period, measured by +/- one standard deviation
3) Projections for CPI from this MPR 1/10 form the basis for this estimate

Sources: Statistics Norway and Norges Bank

Inflation

12-month change. Per cent. January 2006–December 2010[1)]

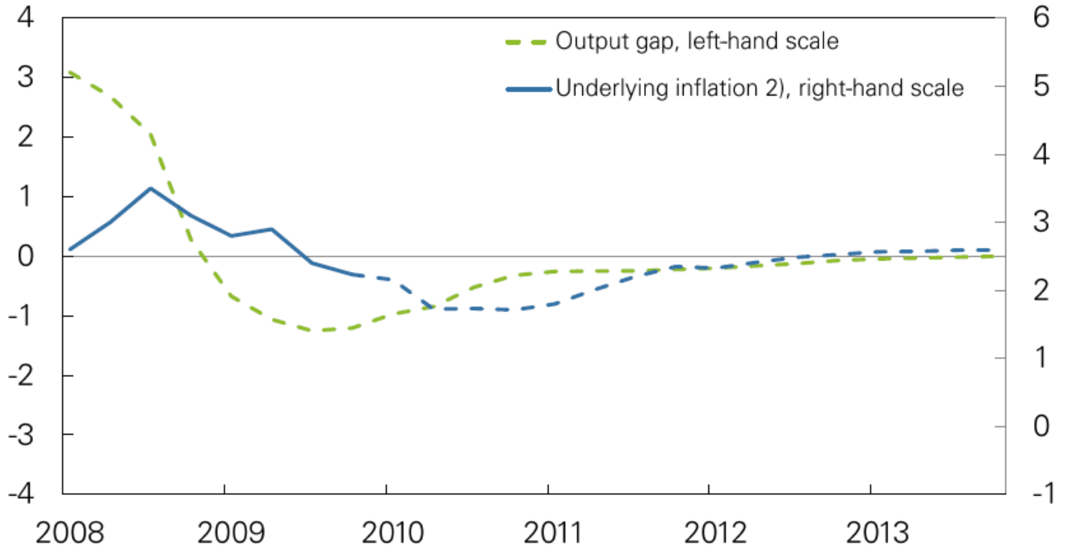


1) Broken lines show projections from MPR 1/10
2) As measured by the CPIXE

Sources: Statistics Norway and Norges Bank

Projected inflation and output gap in the baseline scenario

Per cent. 4-quarter change. 2008 Q1–2013 Q4 [1)]

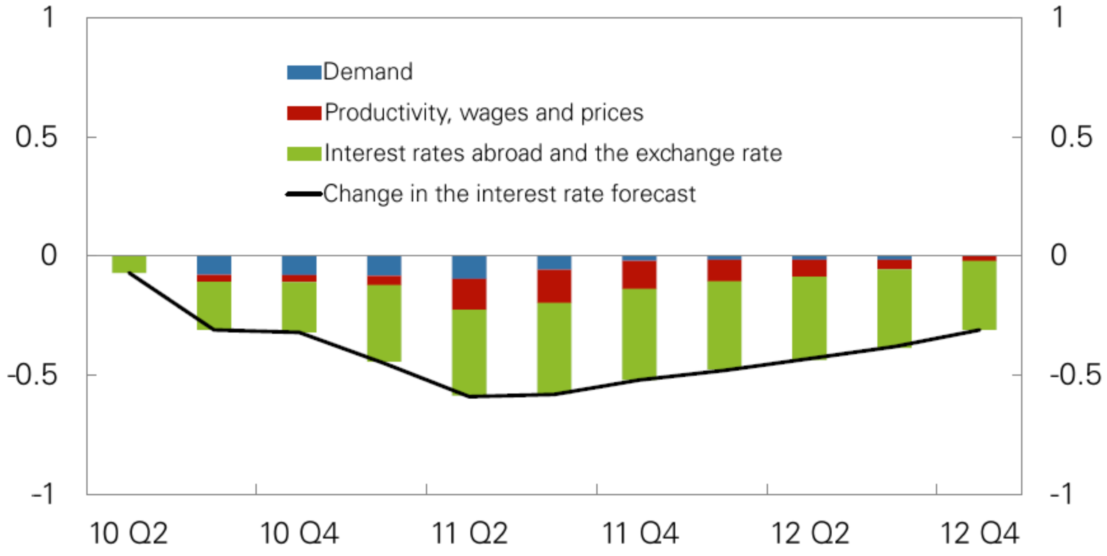


1) Broken lines show projections from MPR 1/10
2) As measured by the CPIXE

Sources: Statistics Norway and Norges Bank

Changes in the interest rate forecast

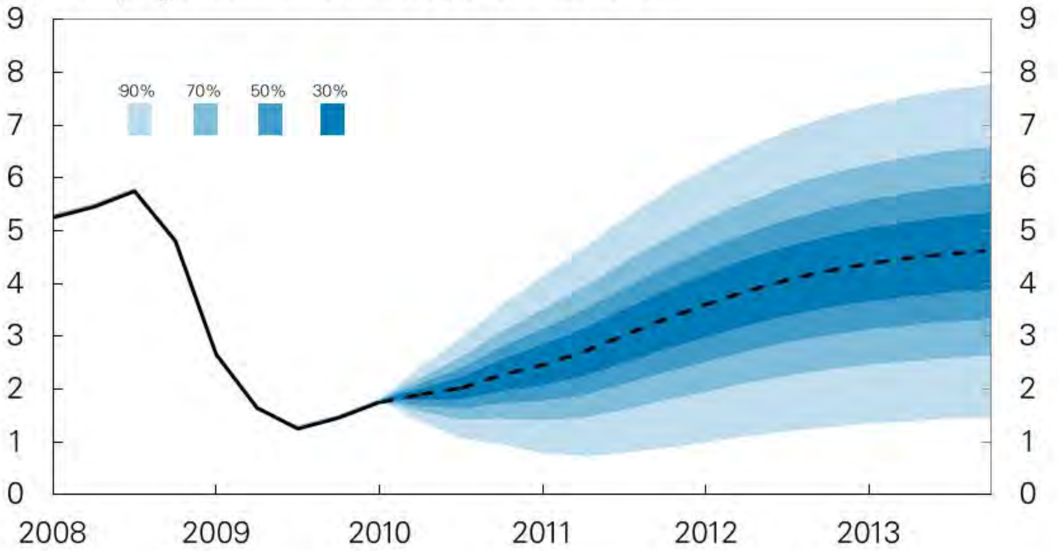
From October 2009 to March 2010. Accumulated contribution. Percentage points



Source: Norges Bank

Projected key policy rate in the baseline scenario with fan chart

Quarterly figures. Per cent. 2008 Q1–2013 Q4



Source: Norges Bank