Economic Perspectives

Address by Governor Torstein Moland at the meeting of the Supervisory Council of Norges Bank on 23 February 1995

Introduction

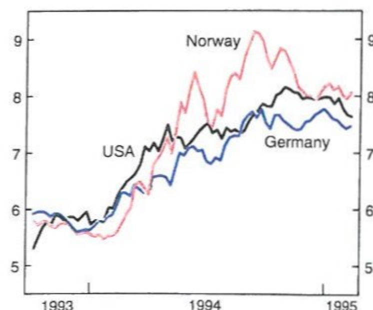
Based on Norges Bank's special responsibilities, much of our attention last year was focused on the risk that a 'No' vote in the EU referendum would be perceived as a signal of a change in direction – moving away from the criteria that we ourselves, and the rest of Europe, have used as the basis for a sound and long-term economic policy. So far, the money and foreign exchange markets have remained confident that we will continue to pursue a stability-oriented policy, and consequently interest rates have again fallen below the European average.

Economic policy requirements will be more or less the same for Norway outside the EU, and will certainly be no easier than if we had joined. The main topic for this annual address is the criteria for a sound economic policy. I will also raise certain central issues related to employment and welfare in the long term. In addition, I will give a status report on monetary policy, and the role of Norges Bank.

The Bank also has a responsibility for financial stability. A year ago, the banks' results for 1993 showed that the banking crisis was over. The upturn in the economy has led to further reductions in loss provisions, whereas the rise in long-term interest rates has had a negative influence on results. Further improvements were recorded in the results for commercial banks last year, whereas savings banks posted a slight deterioration. Increased competition for both banking groups has resulted in narrower interest rate margins which should necessitate further measures to enhance the efficiency of operations. It is important that the banks themselves assume responsibility for maintaining margins which ensure sound earnings and do not forget the risks of an expansionary lending policy. The banks are now able to concentrate on their core responsibilities, i.e loan intermediation, payment services and portfolio management.

Chart 1
Bond yields in the US, Germany and Norway
October 1993 - February 1995

Effective yield on 10-year government bonds, per cent p.a.



Bond yields bottomed out in the US in October 1993. Yields started to rise in most European countries at the end of 1993. Yields in Norway started to rise somewhat later than in other countries, but in February were also on an upward trend.

Source: Norges Bank

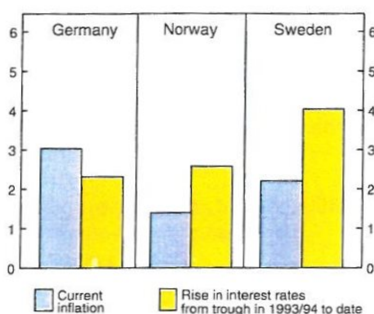
Why did long-term interest rates rise?

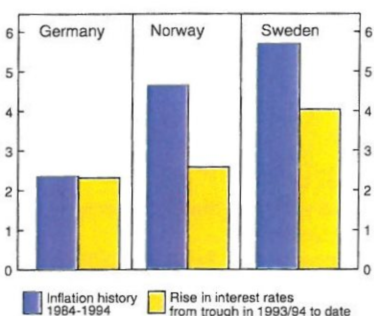
In addition to the EU question, many will remember 1994 as a year when bond yields in industrial countries apparently took on a life of their own. Following a marked downward trend in 1993, bond yields started to rise early in 1994 in all industrial countries, peaking in September/October. In Norway, turbulence in the financial markets connected with the EU referendum entailed that the interest rate differential against other countries remained high, and did not begin to fall markedly until December.

There were few people who could see any substantial economic reasons for the international rise in interest rates nine months ago. With hindsight, however, there is now a clearer understanding of what happened, although there can be little doubt that the market fluctuations were in fact greater than warranted by underlying market conditions. The international recovery that was under way was stronger than anticipated. This led to a greater demand for investment funds that was not matched by increased saving, and therefore higher real interest rates were needed to clear the market. The increase also resulted in an upward adjustment of the market's inflation expectations. Furthermore, the break in the downward trend in interest rates indicated that bond investments are also uncertain and market participants therefore required a higher risk premium.

Chart 2
Inflation and interest rate increases 1994

Per cent





One normally expects a close relationship between price inflation and the level of interest rates. However, current inflation is not necessarily the best indication of a country's ability to control price inflation, and inflation should therefore be studied over a longer period. Germany recorded low inflation in the 10-year period 1984-1994, and only experienced a slight increase in interest rates in 1994, whereas in Norway and Sweden, which both have a less favourable inflation history, there was a sharper rise in interest rates. The increase in Sweden was amplified by substantial fiscal problems.

Source: OECD, Statistics Norway and Norges Bank

A particular feature of this rise in interest rates was that it spilled over from the US into the European markets so quickly. In contrast to previous experience, the development was almost parallel throughout most of the industrialised world, showing that the international capital markets are now more integrated than previously. As a result, we in Norway will be more or less directly affected when, for example, there is a shift in the balance between saving and investment on a world basis. The required return on investment projects will also increase in Norway when this occurs in other countries, as there is now greater competition for the funds that are available and the capital markets are more integrated.

However, not all countries were affected by the rise in interest rates to the same extent. The studies made point to three explanatory factors: inflation, government finances and the balance of payments. It is not simply a case of attributing differences in interest rate increases to differing current inflation rates, but there is a clear pattern when we look at inflation history and interest rate increases. Differences in price and wage inflation are reflected in the longer term by differences in interest rates, even in countries with fixed exchange rates. Inflation history provides the markets with some indication of how the economic and political system copes with situations, impulses and tensions that can give rise to inflation. Even though current inflation does not deviate from the rate in other countries, interest rates can still be influenced by the market's memories of an unfavourable inflation history.

A current account deficit can indicate that a country attracts capital because it has a high return on investment, but it can also reflect a regulatory framework that results in low saving in enterprises and households, and public budget deficits. A current account deficit must always be offset by an equivalent capital inflow, and interest rates are then at the level required to ensure this balance. Thus, the current balance and the factors determining it have a substantial influence on interest rates. This is also the case for the size of government debt. If the debt is high, it indicates that the authorities have not been very successful in pursuing a sound, long-term fiscal policy in the past. Last year there was a particularly sharp increase in long-term interest rates in several European countries with both weak government finances and a poor inflation record.

The conclusions drawn from our own analyses in this field accord with those carried out by other central banks and international organisations. The fact that long-term interest rates are higher in Norway than in Germany, despite our low inflation and favourable budgetary position,

demonstrates that we are still paying for the high inflation we had in the past. In addition, our monetary policy is oriented towards maintaining a stable exchange rate against a wide range of European currencies, including currencies of countries with higher interest rates and less favourable inflation track records.

Criteria for a sound economic policy

The conclusions derived from the analysis of long-term interest rates are also a part of the basis for the Maastricht criteria. They all are aimed at having countries conduct an economic policy that ensures low inflation, a stable exchange rate, healthy public finances and as a result, low long-term interest rates.

Here in Norway, the debate on the Maastricht criteria has partly revolved around the premise that they are not based on the correct priorities and therefore constitute an unnecessary straitjacket, and partly the gratification we feel in satisfying all the criteria. Although requirements for participation in the European Monetary Union are no longer relevant to Norway, it is still important to have criteria that can indicate whether a sound, long-term economic policy is being pursued. The question is, in light of the challenges facing the Norwegian economy, whether the Maastricht criteria are in fact sufficiently ambitious.

The objectives for economic policy drawn up by the Government and the Storting (the Norwegian Parliament) are even more demanding in some areas. I am referring here to the broad consensus that price inflation should be in line with or lower than that of our competitors, that we should maintain a stable exchange rate and that economic policy must aim at keeping Norwegian interest rates on a par with the lowest interest rates in other European countries.

We also need an equivalent reference point for our fiscal policy. The Maastricht requirement of a maximum 3 per cent deficit is only intended to be a minimum requirement for an acceptable deficit in the European Union, and it is also a minimum requirement for countries that wish to participate in stage three of EMU. At the moment there are very few countries that satisfy this requirement.

A balanced government budget has traditionally been an important benchmark, but this variable does not incorporate, for example, the long-term obligations of the social security system. Nor does it reflect that oil revenues will come to an end sooner or later. The fact that oil was discovered provided us with a gift which other countries did not receive.

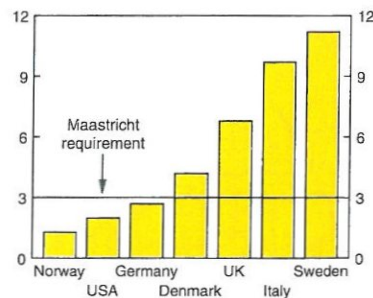
Let us now look at the challenges we face when we take these factors into account, and the criteria which may be applied for pursuing a sound fiscal policy in Norway over a long time horizon.

Budget balance over a long time horizon

The starting point is favourable. As a result of the cyclical upturn and fiscal tightening over the last two years, the general government budget deficit has been reversed to a slight surplus of around 1 per cent of GDP for 1995.

Chart 3
Budget deficits in 1994

Per cent of GDP

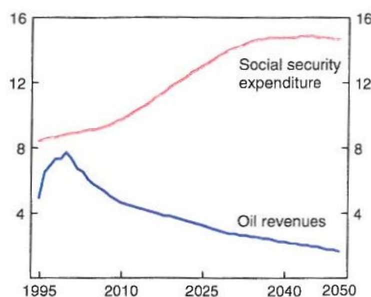


The Maastricht requirement provides criteria for participation in EMU for EU countries. Norway is one of the few European countries that satisfies these criteria, with regard to inflation, interest rates and government finances. The general government budget deficit in Norway, measured by the public sector's net lending, was 1 per cent of GDP in 1994, and a surplus of a good 1 per cent of GDP is likely for 1995. The Maastricht requirement is that the deficit shall not exceed 3 per cent of GDP.

Source: OECD

Chart 4
Government oil revenues and social security expenditure

Per cent of GDP



Central government revenues from petroleum activities in the North Sea will increase sharply in coming years. However, the increase will be reversed to a decline some time in the next century. Central government expenditure for old-age and disability pensions will increase substantially, and will only stabilise after the year 2030, when viewed in relation to total GDP. The decline in petroleum revenues and the increase in social security expenditure will weaken government budgets by 7-10 per cent of GDP in the long term.

Source: Ministry of Finance, Ministry of Industry and Energy and Norges Bank

The situation will probably improve further in coming years. According to the latest estimates from the Ministry of Industry and Energy, the central government's net cash flow from the oil sector will nearly double to approximately 8 per cent of GDP over the next 7-8 years.

Over the long term, however, the picture is not so bright, because at some point we will be adversely affected by two problems simultaneously: Oil revenues will probably fall markedly and social security expenditure will rise sharply. True, oil revenues will not start to decline until after the turn of the century, and for some time will even be considerably above the current level. However, we would not benefit from allowing our current favourable position, compared with the difficulties being experienced by many other countries, to result in such complacency that long-term problems are put aside.

The increase in social security expenditure will primarily be the result of considerable pension payments to the large number of people born just after the Second World War, longer life expectancy and the increase in the number of people who have earned supplementary pension entitlements. Social security pension payments will increase from the current level of 8½ per cent of GDP to an estimated 14–16 per cent at some point in the next century, i.e. an increase of around 6–7 percentage points.

If we combine both the decline in oil revenues and the increase in social security pension payments, these two factors will contribute to weakening government budgets by the equivalent of 7–10 per cent of GDP over a 30–50 year time horizon. Starting with an approximate balance in the budgets, we would then some time in the next century be facing fiscal problems of a magnitude similar to those in Sweden today.

Some will perhaps maintain that this picture is too pessimistic. That may be the case. We cannot rule out the possibility that we may be rescued again, if we are lucky – either by discovering more oil and gas, or by improved production technology which allows us to exploit further current resources, or if oil prices are higher than the assumed constant real price. This would mean that the curve for government revenues from petroleum activities would be higher than shown on the chart. Naturally we all agree that there is hope, but it is very risky *to base plans* on hope, because revenues may also be lower. Technological changes and new environmental requirements could reduce the demand for oil, resulting in lower oil prices.

However, if the problems of higher social security expenditure were to be resolved through an increase in oil revenues, some dramatic upward adjustments would be needed – oil revenues would in fact have to remain at the peak level on a permanent basis, and I have yet to meet anyone who believes this is feasible.

It is also conceivable that social security expenditure could be lower, for example if the rise in the basic pension was to be limited, or earned entitlements were to be changed. The burden on the government budget may also be reduced if we were to eliminate the favourable taxation of pensioners. But this would not occur by itself, and the point is to illustrate possible developments based on the current arrangements.

Others may argue that the problem is so far in the future that we may as well wait and see – maybe a solution will crop up in the meantime. We

have managed relatively well so far, even though we have not built up the substantial National Insurance Fund that was a precondition when the National Insurance scheme was introduced nearly thirty years ago. They are forgetting, however, that it was primarily oil that saved us, and that it will not last forever.

There may also be those who maintain that we should not place equal emphasis on problems facing the next generation as on those confronting us today, and that we should therefore discount both petroleum revenues and social security expenditure. If we use a high discount factor, we can basically disregard as our own problem the fact that the next generation will inherit a government budget with a substantial deficit.

It is not even obvious that we should discount at all if the question is when we shall *use* the petroleum wealth. This raises the difficult issue of whether those alive today have a greater right to use the gift represented by the oil reserves than future generations.

If, on the other hand, the petroleum wealth is transferred from oil and gas to e.g. financial investments abroad, it would be a different matter. Such investments provide a return, and in the past international real interest rates have been in the area of 4–5 per cent. Should we manage to carry out this transformation of petroleum wealth into financial assets, the reduction in oil revenues would gradually be replaced by an increase in other forms of capital income. However, we have not been very successful in doing this to date. The State Petroleum Fund remains empty. Moreover, government financial wealth has been substantially reduced in the past few years, although it may increase again.

We cannot avoid addressing the difficult and key question: what must be done if we are to avoid facing fiscal problems similar to those in Sweden today - in the space of one generation?

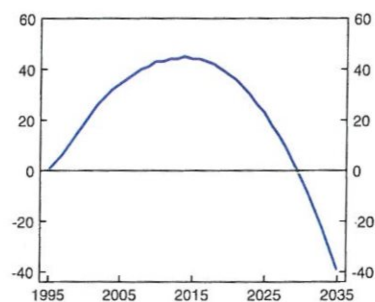
As a minimum, the *increase* in petroleum revenues in the coming years should be set aside. This is not particularly ambitious, and really only entails that we neither tighten nor ease fiscal policy. If all items in the government budget, apart from oil revenues, were to remain constant as a share of GDP, it would entail that the government budget surplus would increase gradually from the current level of a good 1 per cent of GDP to 4–5 per cent over the next five to six years. This could result in a gradual accumulation of funds in the Petroleum Fund, but the fund would still be modest compared with social security obligations. In fact, if we were to do no more than this, the fund would already be empty an estimated 5 years *before* social security payments reach their peak.

Over time there are thus no real options but to tighten fiscal policy. While it is true that we have some time to carry out fiscal retrenchment, this does not diminish the importance of constantly moving in the right direction.

These comments show quite clearly that the Maastricht requirement for general government budgets is far from sufficient for ensuring a sound development in government finances. If we were to establish criteria, adapted to our own fiscal policy challenges in the years ahead, they should contain two requirements. We could perhaps call them the Oslo criteria:

Chart 5
Potential fund if the increase in oil revenues is set aside

Accumulation of funds in per cent of GDP

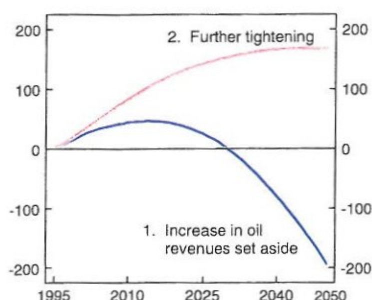


The increase in oil revenues over the next few decades will give the central government opportunities to accumulate financial wealth which can cover higher social security obligations. However, it will not be sufficient to cover the total increase in obligations. In time, the government budget deficit will become so large that it absorbs both the return on the accumulated resources and the fund itself.

Source: Norges Bank

Chart 6
Potential fund resulting from the Oslo criteria

Accumulation of funds in per cent of GDP



The Oslo criteria imply that the increase in oil revenues should be put aside and the general government budget balance should be tightened by 3-4 per cent of GDP over the next ten years. The reserves accumulated on the basis of the first criterion will not be sufficient to meet future obligations related to old-age and disability pensions. However, a fiscal policy in accordance with both criteria will entail that the public sector will build up a financial wealth which is sufficient to cover the higher social security expenditure and to maintain the real value of the funds accumulated. This would entail that a long-term balance is achieved, in the sense that it is not necessary to draw on the accumulated capital in order to meet obligations. The basis for the calculations will be documented in an article in Norges Bank's Economic Bulletin.

Source: Norges Bank

- First, that we from now on set aside any increase in oil revenues, and
- second, that the non-oil budget deficit is reduced by the equivalent of 3–4 per cent of GDP over a ten-year period.

Perhaps this does not sound very dramatic, but it is by taking a small step every year that we can avoid dramatic adjustments. The Oslo criteria nevertheless entail that the budget – including expected oil revenues – will show a surplus of about 6–7 per cent of GDP in the years after the turn of the century. This is considerably more ambitious than the Maastricht criterion of minus 3 per cent, but it does indicate what our long-term objective should be.

The Oslo criteria entail that considerable financial reserves are accumulated to cope with the decline in oil revenues and increase in social security pension expenditure. The question is whether it will be possible to accumulate this wealth in practice, or whether pressures and the temptation to use these revenues become too great. This will probably be one of the major challenges for our political system in the period ahead.

One important problem is naturally inherent in the extension of the Oslo criteria: Where will employment be created when we do not increase the use of oil revenues but tighten fiscal policy while the business sector is being rationalised.

Employment in a long-term context

Throughout the postwar period we have witnessed a gradual reduction in goods-producing industries and an increase in the relative importance of services. Since 1969 more people have been employed in the service sector than in primary and secondary industries combined. Manufacturing employment has been declining since 1974, and service industries have accounted for the growth in employment over the last few decades.

The most fundamental driving forces behind this trend are related to human needs or preferences and to technology in a broad sense:

As income has increased, less of it is used for goods and a higher proportion for such services as health, care, education, travel, etc. The pattern is the same even though the manner in which the service sector is organised varies considerably from one country to another. The same services are in some countries private, financed through sales in a free market and limited by the prices that can be achieved, while in other countries they are part of public services and generally financed through taxes. Looking back, the growth in employment and services from the public sector in Norway has also largely reflected underlying demand from the population.

Technological developments have also contributed to higher employment in the service sector in that there is generally less scope for productivity improvements than in goods-producing sectors. As a result, services have become more expensive relative to goods, and the service sector has become increasingly employment-intensive compared with other activities.

In the last 30 years employment in Norway has risen by about 500 000. An increasing number of people have been drawn into the labour force and we

now have one of the highest participation rates in the world. Current projections show that in the period to the year 2030 we must create between 250 000–300 000 additional jobs if we are to maintain labour-force participation at the current high level and provide access for new groups that reach working age. The dimension of the problem is thus enormous even though employment growth in the previous 30 years was far higher.

Most goods-producing industries are exposed to keen international competition, and manufacturing industry has been scaled back considerably since the beginning of the 1970s. This was partly a necessary consequence of the expansion of the petroleum sector, but also a result of an excessive deterioration in competitiveness. The decline in cost competitiveness has now partly been reversed, and if we take into account that white-collar salaries are lower in Norway than in other countries, our wage level is perhaps on a par with that of our trading partners. We probably also have a level of productivity which does not deviate to any great extent.

The challenge for manufacturing industry is at least to contain costs at this level and in any case avoid another round of deteriorating competitiveness. This might then allow us to halt the decline in manufacturing employment. However, it is not very realistic to believe that we will be able to increase the number of jobs in manufacturing in the time horizon applied here.

But it is not only manufacturing industry that is dependent on maintaining competitiveness. Mounting competition from other countries entails that the level of costs is also of increasing importance to the building and construction sector and many service industries.

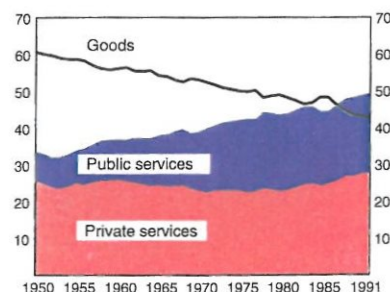
Service sectors are also expanding in close conjunction with other industries and are dependent on supplying services to them. According to the OECD, more than half of the production in service sectors in industrial countries is directly linked to the production of goods, if we disregard government services. This demonstrates that we cannot ignore the importance of goods-producing industries to employment. There are nevertheless many indications that services will be the source of employment growth in the years ahead.

Both needs and technological developments imply that virtually the entire growth in employment of 250 000–300 000 will take place in services and provide improved coverage of the services in demand. The big question is whether we succeed in organising society in such a way that we are successful in achieving this.

I have pointed to competitiveness as an important factor. The same is true for employees' skills and capacity to adjust, and the wage structure. There is a feeling in many circles that the industrialised world is facing the choice between the plague and cholera: With a wage structure which reflects productivity differentials the problem of employment can be resolved, but there will be considerable disparities and a serious problem of poverty. A more even wage structure and social welfare arrangements can help to combat disparities and poverty, but unemployment then becomes unmanageable.

In Norway we have succeeded better than most. Compared with other countries we have limited wage differentials, little poverty and low unem-

Chart 7
Composition of consumption 1950–1991

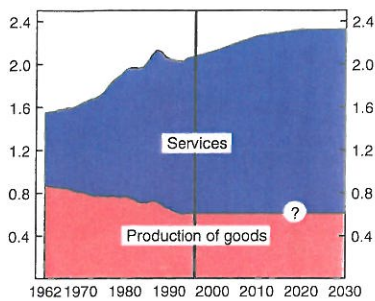


The composition of total consumption, both private and public, has changed substantially since 1950. Measured in current prices, private consumption of goods has fallen from a good 60 per cent to about 40 per cent. The consumption of services, both those paid for by consumers and those made available to consumers by the public sector, has increased from around 35 per cent to 50 per cent of total consumption. The total increase in consumption of services is ascribable to the rise in government produced services. The share of consumption that comprises collective goods such as expenditure on the military, the police, the legal system and public administration, has remained constant at just under 10 per cent from 1950 to the present day. This share of consumption is not shown in the chart.

Source: Statistics Norway

Chart 8
Employment by sector 1962–2030

In millions of persons



Employment in goods-producing industries, agriculture, manufacturing and building and construction sectors etc. has fallen markedly in the last 30 years. Service industries such as distributive trades, domestic transport, business and social services, etc. have not only compensated for the fall in employment in goods-producing industries, but have also been the basis of a sharp increase in labour-force participation. If we are to maintain the current level of labour-force participation and provide room for new groups that reach working age, we must ensure that employment increases by more than 250 000 in the period to the year 2030. At best we can hope that the decline in employment in goods-producing industries will not continue to fall so sharply, but this entails that growth in employment must then take place in service industries.

Source: Statistics Norway and Norges Bank

ployment. But even in Norway there are problems for groups of employees. It is probably unavoidable that this will have to be tackled through a sufficiently low average wage level, i.e. a strong competitive position, with an upgrading of the qualifications of non-skilled labour and with starting pay which helps to ensure that everyone gains access to the labour market.

However, there are some aspects of the employment challenge now facing us that are so different from earlier periods that competitiveness and a well functioning labour market are not sufficient. In the last 30 years the public sector has accounted for as much as 80 per cent of the growth in employment. This has been financed by increased taxes, the use of oil revenues and by postponing solutions to problems associated with social security obligations. This approach cannot continue for another 30 years. Nor can employment be safeguarded on a durable basis if we consume the petroleum wealth or shift the burden to the next generation. Fiscal policy should instead have a long-term orientation in line with what I have called the Oslo criteria. We must therefore look for other solutions if we are to increase employment.

We must also assume that an increasing share of demand will be directed towards health, care and other public services, and that much of the growth in employment will take place here. However, creating scope for this within the limits of acceptable budgets will be extremely demanding. Higher taxes to finance these services will involve considerable social costs which reduce growth possibilities. Large-scale cuts in other government budget programmes will arouse considerable resistance. The same is true of an extensive reordering of priorities and the use of the price mechanism in the public sector.

However, if these services are instead to be financed privately so that the growth in employment takes place in the private sector, other problems arise which many will find just as difficult. In the extreme, we may – based on the current organisation and financing of the public sector – find ourselves in a situation where we do not succeed in meeting the higher demand for services like education, health and care, or in creating the necessary employment.

The problem, however, is that if we fail to do everything that is difficult, we end up with an over-determined system. Something then has to give whether we like it or not. If we are to increase employment, fulfil our social security obligations, and satisfy the demand for health and care services, etc., it is our unwillingness to make difficult decisions that must give way. In any case considerable changes in accustomed arrangements may be necessary.

There are no simple solutions to these dilemmas. Because the choices are more difficult than earlier, this will probably be a recurring debate in the years ahead. I would like to comment on a few problems in this connection: the costs of a further increase in taxes, the possibilities opened up by the tax changes and a reordering of priorities by cutting transfers to industries.

The costs of taxes

The public sector has expanded in tandem with a sharp rise in the tax level. To all appearances it has not been very problematic to raise taxes from 30 to 50 per cent of GDP. It takes time before the costs emerge, but there are obvious limits as to how much taxes can be increased without having considerable negative effects for the economy. In the case of Sweden the question is now being raised as to whether the high level of taxes is part of the reason that the country's ranking on the list of the world's richest countries has been reduced from number 3 in 1970 to number 17 in 1993.

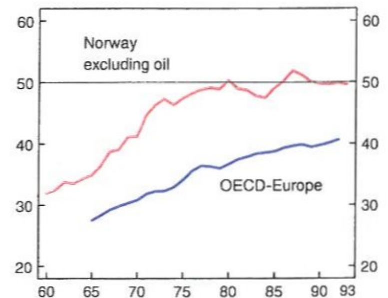
Initially, direct and indirect taxes are a transfer of purchasing power from the private to the public sector, and as such are not a cost to society. Indirectly, however, they are because they distort the role of prices as conveyers of information. They create tax wedges. An example illustrates this: When NOK 300 is paid for a good, the one contributing the productive input is left with only about NOK 100 after VAT, payroll taxes and income taxes are paid. Or in other words: When a productive input is paid NOK 100 after taxes, the input creates values for which consumers pay about NOK 300. Direct and indirect taxes make up the difference, i.e. the tax wedge. As consumers we thus do not receive correct information about society's production costs, and as providers of productive inputs in the form of labour or saving we do not receive correct information about society's benefit from this input.

Over the last few years Norway and other countries have made considerable efforts to arrive at a quantitative estimate of the social costs of these taxes. These studies are naturally uncertain, but they indicate that in general the social cost of collecting 1 krone in taxes amounts to 50 øre. A withdrawal of 1 krone in the form of taxes should then create values of at least 1.50 in the public sector in order to be socio-economically profitable.

This implies that there are limitations as to how much the tax level can be increased without having major negative effects on economic growth and thereby the total level of welfare.

Chart 9
Tax levels 1960–1993

Per cent of GDP



The level of direct and indirect taxes in Norway rose swiftly in the 1960s, peaking at a level of around 50 per cent of GDP in the mid-1970s. Since then, the rise in public expenditure has been increased through higher revenues from petroleum activities. The share of GDP in the Norwegian economy, excluding oil, that is channelled to government budgets by means of taxes and excise duties, has thus remained around 50 per cent. By way of comparison, the average tax level in other European countries today is around 10 percentage points lower than in Norway.

Source: Statistics Norway and OECD

The tax system

It is not immaterial from a socio-economic point of view what types of taxes are imposed on individuals and enterprises, labour and capital. The average figure of 1 krone and 50 øre conceals substantial variations from one type of tax to another. Statistics Norway has drawn up estimates for this which tally well with international studies. If we look at taxes that do not influence work and saving, the use of 1 tax krone requires marginal value added of 1.20. The equivalent figure for VAT is 1.35 and for income tax 1.75. Taxes with a broad base have a lower efficiency cost than taxes with a narrow base, and the taxation of goods and services with low price sensitivity have a lower cost than those with high price sensitivity.

Studies in other countries show that broadly based tax reforms with a given tax revenue may generate economic gains in the order of 5 per cent of GDP. Norway probably had this same potential prior to the tax reform in 1992. However, the analyses made support the notion that there is still a considerable potential for reducing the social costs of the tax system. It has been estimated, for example, that only 40 per cent of the potential for effi-

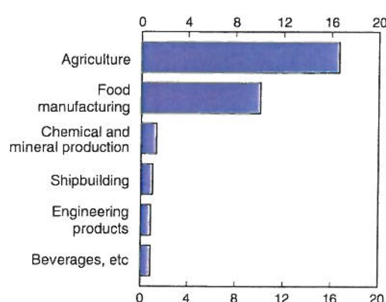
ciency gains in the taxation of capital was drawn from the tax reform of 1992 because the taxation of housing was excluded. Considerable economic gains were nevertheless achieved through the tax reform. It is important that these gains are preserved and not wasted by again introducing undesirable modifications.

In order to achieve these economic gains with no changes in the tax level, tax rates must be reduced by broadening the tax base or by expanding those taxes which involve limited costs. A number of special arrangements and exemptions exist for both incomes taxes and VAT which contribute to high rates and thereby sizeable costs. Property taxes and particularly land taxes are an unexploited type of tax in Norway. These are taxes which involve very limited distortional effects and costs, and for which the economic gains may be particularly great if the revenues are used to reduce income tax rates. Environmental taxes are also advantageous based on the approach used here. Even though the remaining potential is perhaps not that great, these green taxes may actually result in increased economic efficiency – and not costs.

Transfers to industries

Chart 10
Effective support to industries in 1991

In billions of NOK



The effective support to industries comprises government support to industries in Norway directly over government budgets, through advantageous input prices for the industry and through sheltering the domestic market for its products. Calculations take into account those industries which derive the real benefit from the various types of support. Agriculture and the food manufacturing industry receive the highest effective support. However, effective support does contribute considerably to other industries' ability to remunerate labour and capital.

Source: Statistics Norway

The National Budget indicates that each year we generally use NOK 25 billion for direct government budget expenditure on support to various types of industries in the form of subsidies and tax exemptions. The effect of special arrangements which still exist in the tax system comes in addition. Of special importance is the additional profit earned by individual groups when competition is regulated, for example in the form of import restrictions. These various types of support to industries have recently been systematised by Statistics Norway. Altogether the effective support amounted to about NOK 33 billion in 1991.

In the study, the effective support for an industry measures how the ability to remunerate labour and capital is influenced by import restrictions, advantages due to tax exemptions, subsidy arrangements, etc. Account has then been taken of interindustry relationships, entailing that the support is assigned to the industry which has the real benefit. The calculations show considerable differential treatment of industries. Not unexpectedly, agriculture is the largest recipient of such support. As a result of import restrictions, however, the food manufacturing sector and a number of other industries also receive considerable amounts.

The effect of this support is that resources are tied up in activities which have a lower return than if they had been used in other industries. Private profitability is then at the level required for such industries to attract labour and capital. For the economy as a whole, however, the value of the goods produced is reduced when measured by world market prices, and as a rule this is the relevant factor for such goods. Reduced support to industries will contribute to a pattern of production which to a greater extent reflects the real competitive advantages in the Norwegian economy.

Such adjustments involve costs in the short term. Many will also maintain that support to industries serves a number of sensible purposes. The point in this connection is that these transfers are designed in such a way that they involve social costs in excess of the cost of financing them.

Difficult choices

When drawing up a status report one generation from now, we will most likely have experienced a sharp growth in employment in services – in both the public and private sector. Whether this growth will be sufficient, however, to ensure full employment is not obvious. It will depend, among other things, on to what extent we succeed in addressing the dilemmas I have discussed earlier.

If we attempt to solve them by increasing the level of taxes, the costs involved will have the effect of reducing growth. Further tax reforms, on the other hand, may contribute to higher growth and thus to an increase in total disposable resources.

There are considerable socio-economic gains to be derived from a combination of reduced support to industries and a reduction in those types of taxes which entail considerable costs. Both will help to improve the way in which the economy functions, thereby enhancing the basis for growth in employment in the private service sector. By easing pressures on the budget, reduced support to industries may alternatively provide scope for public services.

Both tax reforms and the scaling back of state aid to industries are important, but far from sufficient for creating the basis for the necessary growth in private and public sector employment. The employment challenge will probably require a review of the entire range of transfer payments, including those to individuals, an examination of the division of responsibilities between the public and private sector, and a greater use of the price mechanism and other efficiency-enhancing measures in the public sector.

In other words: There are no simple solutions in spite of higher oil revenues for some years. It does indicate, however, what is necessary to safeguard employment on a durable basis so that we avoid passing on burdens to later generations.

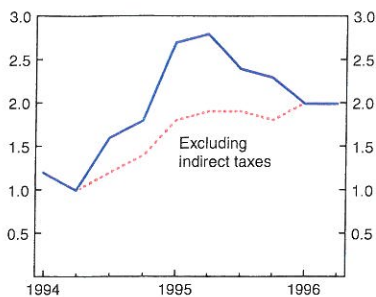
Status for monetary policy

The new guidelines for monetary policy that were established in connection with the Revised National Budget were based on the main economic policy objectives of full employment and sustainable growth, as set out in the Long-Term Programme. There was broad support for Norges Bank's evaluation that low price and wage inflation are necessary to achieve these primary objectives, and that in the long run there is no trade-off between higher inflation and higher employment. On the contrary, broad recognition has gradually been gained that high inflation weakens the basis for growth and employment. This is also supported by concrete surveys in a number of countries and is the underlying premise for their monetary policy.

The different monetary policies conducted by the most important industrial countries through 1994 can primarily be attributed to differences in economic developments. The monetary policy authorities have to a greater extent than previously adopted the precautionary principle. Interest rates have been increased in the US and the UK – not based on current inflation

Chart 11
Consumer prices

Percentage growth

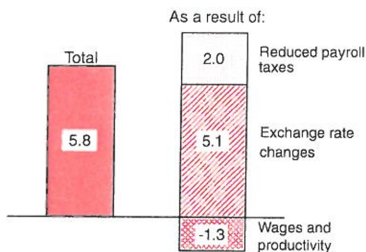


Average price inflation was 1.4 per cent in 1994. The increase in excise duties on 1 July 1994 and 1 January 1995 has resulted in a marked rise in the yearly inflation rate. Inflation stood at 2.6 per cent in January this year, while in April/May 1994 it was 0.9 per cent. Norges Bank's latest estimate is consumer price inflation of 2½ per cent for 1995 on a year-on-year basis. Inflation will peak in April/May, before falling to around 2 per cent towards the end of the year.

Source: Statistics Norway and Norges Bank

Chart 12
Improvements in competitiveness 1992–1994

Per cent



Wage costs for Norwegian manufacturing industry fell by 5.8 per cent between 1992 and 1994, compared with the average of our most important competitors. This improvement in competitiveness is partly due to the 2.0 per cent reduction in payroll taxes at the end of 1992 and partly to the 5.1 per cent fall in the Norwegian krone's effective exchange rate. Growth in wage costs per man-hour, excluding payroll taxes, was 0.1 per cent lower than the increase in wage costs in competing countries. On the other hand, productivity gains have been weaker in Norway than in other countries, thereby weakening competitiveness by 1.4 per cent. Developments in wages and productivity combined have entailed that competitiveness has deteriorated by 1.3 percent.

Source: The Technical Reporting Committee on Income Settlements

figures – but following an evaluation of the outlook for the next 1½–2 years. In continental Europe the recovery is still at an early stage, and it has not been necessary to raise interest rates. Nor, it may be added, had short-term rates in these countries been pushed down to the low levels recorded in the US.

Even though the Norwegian krone is currently floating, the operational target for Norges Bank's implementation of monetary policy is to contribute to a stable krone exchange rate against European currencies. If we are to succeed, price and wage inflation must be on a par with or lower than the level in these European countries.

Price inflation presented no problems last year. The problems associated with the conduct of monetary policy were also relatively limited compared with what Norges Bank has experienced earlier. Norges Bank's key interest rates for banks have remained unchanged for more than one year, and money market rates have stayed within the interval between the deposit rate and overnight lending rate. The exception was during a short period prior to the EU referendum when money market rates were higher than the overnight lending rate. Interest rates are now at the lower range of the interval and the Norwegian krone has appreciated.

In my view, the situation is favourable for stable money markets in the near future, even though we must always be prepared for some surprises in this area. The cyclical upturn was robust last year, but from an economic situation with excess capacity. It now appears that the strength of the upturn has slowed to a sustainable level. Growth in consumption has also been reduced and investment has taken over as the strongest domestic driving force. Wage growth was estimated at 2¾ per cent last year, and there are, as yet, few signs of any wage reactions to the tightening of the labour market.

The rate of price inflation in 1994 was one of the lowest ever recorded. Such a low figure as 1.4 per cent has not been registered since 1960. The turn for the worse in 1994, which has now been amplified, is primarily ascribable to the increase in excise duties and VAT last summer and on 1 January. Assuming that these excise duty hikes do not trigger cost compensation, the rise in price inflation should only be temporary.

It is particularly important in this situation that we secure confidence in Norway's position as a low-inflation country. The coming wage settlements are the key to this. We are now at the stage where it seems likely that our competitiveness will no longer improve, possibly indicating that Norway is at a more advanced stage of the business cycle than our trading partners. What is worrying is that our analyses show that we could embark on a trend of steadily deteriorating competitiveness in the years ahead if the mechanism for wage formation continues to follow its traditional course.

Price and wage inflation in the world around us is now at an all-time low. Any domestic inflationary impetus will thus be offset by low external impulses, and price inflation will therefore probably remain low in absolute terms. But a negative trend relative to other countries involves the potential of unstable developments.

The Employment Commission assumed that it would be possible to keep wage cost increases 2 per cent below the level of our trading partners, even when the economy was expanding. However, this has proved to be substantially more difficult than anticipated by the Commission. The considerable improvement in competitiveness since 1992 is almost entirely due to other factors: a reduction in payroll taxes and a lower value for the Norwegian krone after it was floated. We have not achieved notably lower wage growth than other countries, as was assumed, and productivity growth has been weaker. In the current situation with low wage growth in other countries, there is little scope for an annual improvement of 2 per cent in the years to come. If, however, we fail to keep wage growth on a par with our competitors, we have definitely not succeeded in addressing the challenges outlined by the Employment Commission.

Norges Bank's role

Norges Bank was assigned clearer responsibilities in the new guidelines for monetary policy. The Bank has two important functions in this connection:

The operational or executive function is to ensure that the krone exchange rate remains stable. This determines our market operations.

As advisor to the Government on monetary, credit and exchange rate issues we focus on the preconditions for maintaining a stable exchange rate. In our advisory function we therefore cover all elements of economic policy which must be formulated in such a way that low price and wage inflation can be continued. In this way our advice is also focused on how the primary objectives of full employment and sustainable growth can be achieved. Our evaluations are presented in our quarterly economic surveys, which now concentrate on price and wage trends, in our statements concerning economic policy and in lectures like the one today. By doing this, we also fulfil our obligation to inform the general public of the basis for monetary policy.

This may lead some to believe that because we have placed greater emphasis on analyses of factors that can jeopardise low price inflation, we are of the view that this is more important than high employment. This is of course not the case. However, over the last few years we have learned that the source of higher unemployment is found in periods of economic expansion. An excessive upturn that triggers inflation pressures is usually followed by a strong downturn, which is when unemployment rises. This happened in Norway as well as in other countries. A sound and long-term oriented policy during an economic expansion is therefore the best strategy for avoiding new recessions.