Norway's changing economy

Address by Governor Svein Gjedrem at a meeting hosted by Sparebank1 Nord-Norge, Bodø, 3 December 2002

The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 30 October and on previous speeches. A preliminary assessment of some new aspects of economic developments is also presented.

Please note that the text below may differ slightly from the actual presentation.

A year and a half ago, the Government and the Storting adopted new guidelines for economic policy. Over time, the use of petroleum revenues is to be equivalent to the expected real return on the Government Petroleum Fund, i.e. 4 per cent of the Fund.

The use of petroleum revenues is reflected in the structural, non-oil government budget deficit. It is this deficit which, according to the fiscal guideline, should be 4 per cent of the value of the Fund over time. This means allowing higher tax revenues to strengthen the budget balance during a boom in the economy, and to have the opposite effect during a downturn. This means that the automatic stabilisers will function.

Norges Bank shall set the key rate with a view to maintaining low and stable inflation. The inflation target is set at 2½ per cent. The Government has indicated in the National Budget that monetary policy should be the first to react when the outlook for the economy changes. A situation may nevertheless arise in which an active use of fiscal policy is required, either because capacity utilisation is particularly low, or because pressures in the economy are very strong.

There are good reasons why monetary policy is oriented towards keeping inflation low and stable. There are costs associated with high and variable inflation. It increases uncertainty about future income and expenses among households and enterprises. and leads to unsound investments and wider fluctuations in the economy. It is equally important to avoid deflation, a fall in prices, because this often accompanies and can amplify a downturn.

Low and stable inflation is the best contribution monetary policy can make to growth and stability in the economy.

We have had four periods of very high inflation over the past 100 years; during the two world wars, the Korean War and a 15-year period from the first half of the 1970s to the second half of the 1980s. In Norway, very high inflation is a wartime phenomenon and a 1970s and ’80s phenomenon. Substantial real economic losses and financial instability have followed in its wake.

The fourth period of high inflation was unlike the three previous periods. In the 1970s and ’80s, inflation accelerated gradually. It was not as high as during the two world wars, but it took a long time for the level to fall. The fixed exchange rate system of the post-war period, the Bretton Woods system, broke down in 1971. The Yom Kippur War followed two years later, with the OPEC countries' oil embargo and the first oil crisis. The sharp increase in oil prices led to a fall in productivity growth and to stagnation and higher unemployment in Western economies. At the same time, inflation took root in many countries.

High and variable inflation also contributed to wide swings in output and employment. These wide fluctuations culminated in the credit boom and spending spree of the mid-1980s, followed by a deep recession and high unemployment towards the end of the 1980s.

The marked fluctuations of the 1970s and 80s were due to the lack of a nominal anchor in the Norwegian economy, in the form of stable prices or a stable exchange rate. High and variable inflation was countered by frequent devaluations. This did not promote stability in the economy.

History shows that low unemployment cannot ultimately be achieved through high inflation. A monetary policy that contributes to inflation does not create higher economic growth. On the contrary, it paves the way for recession and unemployment.

Global capital markets have become more closely integrated. Investment across national borders is easier and less risky. The role of the foreign exchange market in financial markets has become increasingly important. Today's global economy is characterised not only by extensive cross-border trade in goods and services, but also large capital flows. The opening-up of capital markets and Norway's trade relations with the rest of the world have taken on decisive importance for economic policy in two areas in particular.

First of all, Norway's large petroleum resources in a world of free trade might be converted into substantial revenues for the country, and the surplus invested abroad. This poses particular challenges to stabilisation policy. Norway's export and central government revenues can be expected to be very high as long as production remains high. At the same time, we know from experience that revenues may vary sharply from year to year. As a result of the high level of earnings and fluctuations in these revenues, the most important contribution fiscal policy can make to stabilising the Norwegian economy is to provide a sound, long-term strategy for the use of petroleum revenues. Attempts to use the central government budget to fine-tune economic activity may, at worst, have a destabilising effect if these attempts are perceived as being a breach in the long-term strategy for the phasing in of petroleum revenues. It is necessary to show that fiscal policy is applied symmetrically in periods of economic expansion and contraction.

Second, economic agents look to the future when they make decisions about consumption and investment, wages and prices. They will take economic policy into account, not only as it is today, but also as they expect it to be in the future. This is particularly evident in foreign exchange and financial markets, where exchange and interest rates are influenced when participants shift large amounts partly on the basis of their expectations concerning economic policy and economic developments. The issues that receive attention, and that govern movements in exchange and interest rates, change. It is thus important that the authorities do not sow doubt, but on the contrary act in a predictable manner within a long-term framework. The authorities must be credible and inspire confidence. There must be consistency between the stated objectives of economic policy and what is actually done to achieve them. This is the most important reason why the implementation of monetary policy has been delegated to the central bank in Norway, as has been the case in other comparable countries.

The agreed compromise on the central government budget for 2003 between the Government and the Progress Party implies reallocations equivalent to NOK 6.3 billion in accrued terms and NOK 4.4 billion measured in recorded value. Real underlying budget spending growth from 2002 to 2003 is estimated at about ½ per cent, and the structural non-oil deficit is projected at NOK 30.7 billion. These figures are the same as in the Government's original budget proposal.

According to the budget compromise, municipal finances will, in isolation, be strengthened by NOK 1 billion. This is equivalent to about ½ per cent of local government revenues. At the same time, however, local government tax revenues are now projected to be NOK 1 billion lower in 2002, with the possibility of lower tax revenues again next year.

In the central government budget for 2003, the projections for the use of petroleum revenues up to 2010 have been revised downwards considerably since the presentation of the Long-Term Programme, the National Budget for 2002 and the Revised National Budget for 2002. This may mean that the phasing in of petroleum revenues will take place at a more gradual pace than had been assumed.

The krone has appreciated considerably since summer 2000. There may be many reasons for this.

Relationships in the foreign exchange market are unstable. There are nevertheless some fundamental forces that influence the krone exchange rate.

The phasing in of petroleum revenues and the economic situation affect the exchange rate. In addition, the real exchange rate has a tendency to return to its normal range if there are substantial deviations over time.

Moreover, the krone can be influenced by shifts and changes in wage formation, and the krone exchange rate can also be affected by external factors.

Increased spending of petroleum revenues or expectations of increased use of petroleum revenues may lead to an appreciation of the krone. Increased use of petroleum revenues over the central government budget implies higher demand. The contest for economic resources will then result in a further scaling back of internationally exposed industries to make room for more activity in the sheltered sector. With low and stable inflation, this restructuring might take place as a result of a stronger krone exchange rate.

Such exchange rate movements will typically come in waves. As petroleum revenues are being phased in, the real interest rate will tend to rise. The real exchange rate may appreciate, which means deterioration in competitiveness. The real krone exchange rate may move more in the short term than is necessary in the long term. The krone may be expected to depreciate at a later stage because a higher real interest rate, combined with expectations of a depreciation of the krone, contribute to convergence between the expected real return on capital invested in Norway and in other countries. Moreover, there may be additional fluctuations in the krone exchange rate if market expectations concerning the use of petroleum revenues deviate from what is actually the case. Given today's exchange rate, it would appear that foreign exchange operators have already priced in an increase in the use of petroleum revenues.

The business cycles are reflected in the interest rate differential between Norway and Germany and the US. What makes the current situation unusual is the extremely low foreign interest rates. Foreign interest rates have been reduced substantially to counter a downturn. High and widening interest rate differentials have probably contributed to the appreciation of the krone.

Even though the krone is strong, expectations concerning the strength of the krone in the period ahead are not particularly high. If kroner are bought forward for delivery a few years ahead, and the exchange rate is agreed today, it will be at an exchange rate that is on a par with the average exchange rate for the 1990s.The cyclical divergence that is reflected in the krone exchange rate is not entirely disassociated from our position as an oil economy. At least since the end of the 1990s, it seems that enterprises, households and employees have adapted to expectations of strong income growth. This may have contributed both to the appreciation of the krone and to widening the cyclical divergence between Norway and other countries. If the increase in the use of petroleum revenues has already been priced into today's exchange rate, both the long-term trend in the real exchange rate and interest rate expectations suggest that the krone exchange rate will return to a more natural long-term range.

During the 1990s, we saw that unemployment declined as long as wage growth in Norway was lower than wage growth among our trading partners. This came to a halt in 1998, when the social partners rejected a policy of wage moderation. Unemployment stopped falling.

The sharp rise in labour costs in recent years carries with it a potential for higher unemployment. The interest rate is an effective instrument for countering changes in demand and keeping inflation low and stable. When inflation is low and stable, changes in the interest rate can also contribute to maintaining stability in output and employment. However, there is little monetary policy can do to prevent an increase in unemployment that is driven by high cost inflation.

For a long time, a stable exchange rate and the level of cost inflation among our trading partners provided an anchor for wage determination in Norway. Since 1998, however, the rise in labour costs in Norway has been around 2 percentage points higher than that of our trading partners. The outlook suggests that cumulative wage growth in Norway will be a good 15 per cent higher than in other countries from 1998 to 2003. High wage growth, combined with the global downturn and a strong krone, is having a severe impact on manufacturing industry.

The krone is now about 9 per cent stronger than the average for the 1990s. The appreciation of the krone is probably reversible, but the loss of competitiveness and jobs caused by the relatively high level of domestic wage growth is difficult to recoup.

Over time, the size of the internationally exposed sector will be affected by the portion of petroleum revenues that is absorbed in the Norwegian economy, but will be unaffected by monetary policy. Any strengthening of the krone exchange rate may nevertheless affect how quickly the changes in the business sector take place.

Export industries generate foreign-exchange earnings to finance imports of goods and services. Industries that are exposed to international competition are also important to the growth potential of the economy. Scaling back manufacturing therefore involves a risk. It makes the economy more vulnerable. The growth potential of the economy - the basis for learning, innovation and development - may be impaired when less of the business sector is exposed to intense international competition.

Over the last thirty years, manufacturing has been scaled back in waves, and particularly sharply in the periods 1977 to 1984 and 1987 to 1992. In the years leading up to the periods of contraction, profitability in the manufacturing sector deteriorated. It can take time for such a deterioration to translate into lower output and employment. But when the turnaround does occur, it tends to be swift and pronounced.

Norway is, however, not alone. A trend decline in manufacturing industry is evident in all countries. The pace of the decline differs from one country to another, with the US recording the sharpest fall.

Developments in recent years may herald a new round of restructuring in manufacturing industry. Global economic decline amplifies the effects of restructuring and contributes, in isolation, to weakening the economic outlook. On the other hand, the oil price, investment and activity in the petroleum sector have so far remained high.

Weak developments in the global economy over the last few years are reflected in equity prices. Prices on most stock exchanges have fallen considerably since the beginning of the year. Equity prices in the various countries have a tendency to shadow each other. The impact of the decline has been felt by many countries simultaneously. Developments this summer indicate that the international recovery may be weaker, and come later, than had been expected earlier this year.

The global fall in equity prices has also spread to the Norwegian stock market. There is a close relationship between equity prices in the US and in Norway. A sharp fall in share prices may also have a dampening impact on activity in the Norwegian economy, even if the effects are considerably milder here. The wealth of households that own shares will diminish, and they will reduce their consumption. Share price movements may also have a negative impact on business and household expectations, and make it less attractive to invest in new production capacity.

US consumers have become more pessimistic about economic developments. Recently, however, the figures have been somewhat more positive. After falling sharply through the summer and autumn, expectations rose somewhat from October to November this year.

In Europe, expectations have been lower in the past year. Developments in Germany in particular give grounds for some concern. Growth is stagnating, and households and enterprises are more pessimistic about the future.

Expectations in the manufacturing sector and among households are also lower in Norway.

The decline in the equity market, a weaker outlook for global economic growth and a higher interest rate in Norway have so far had little effect on the willingness of Norwegian borrowers to incur debt. The total debt burden in the household sector is high, although still lower than at the end of the 1980s, measured against household disposable income. The debt burden for the lower and middle income group is, however, higher today than ever before. In the event of a loss in income or an increase in the interest rate, households in this group may experience problems servicing their debt.

Household financial saving (net lending) has dropped to almost zero in the past couple of years. Combined with high wage growth, this has given rise to strong growth in household consumption. However, lower expectations may be the first sign that households will be more cautious than before.

There are some signs of weakness in the job market. Registered unemployment has edged up over the past year, to 3.3 per cent in October (seasonally adjusted 3.5 per cent). Unemployment has risen in all counties and among all occupational groups, with the exception of primary industries. However, unemployment is rising in particular in some service industries. At the moment, there is no sign of substantially higher unemployment in typical manufacturing counties. The increase in unemployment is particularly related to restructuring in some sectors, among them the IT sector, transport and communication and parts of the private service sector. We have not yet witnessed the full effect of weak competitiveness on manufacturing employment and on industries and regions that are particularly dependent on manufacturing industry.

Information obtained via the regional network established last autumn was used when preparing the October Inflation Report. We will have six rounds of talks each year with business and community representatives concerning financial developments in their enterprises and industries. There will be a total of about 200 visits in each round. We have divided the country into 7 regions and established links with regional research institutions in six of them. These institutions will hold meetings with the representatives on behalf of Norges Bank. Northern Norway is covered by the innovation centre here in Bodø.

Reports have been received from Region North that the strong krone combined with a costly wage settlement is contributing to deterioration in competitiveness in export-oriented industries. This has recently resulted in considerably lower demand and turnover in companies supplying goods and services to these industries.

Companies in the north are reporting lower demand and falling profitability. The tendency is the same in most sectors with the exception of retail trade and other private services for the household sector.

Retail trade companies in the north have recently experienced an increase in turnover. It is expected that this trend will also continue in the coming months. At the same time, we are receiving reports of substantial "trade leaks" to Sweden as a result of cross-border shopping.

In construction, manufacturing, service provision and trade in capital goods, companies have reported a shift in activity to the public sector.

The table shows the economic outlook as assessed by the Executive Board of Norges Bank before its monetary policy meeting on 30 October this year. The figures and conclusions are from the *Inflation Report* that was presented on the same day. Norges Bank projected high growth in private consumption, partly due to strong wage growth in the public sector. Mainland investment is exhibiting sluggish growth, while petroleum investment is expected to be high next year. Mainland GDP growth was expected to pick up through the projection period and reach 2½ per cent in 2004.

The projections for inflation were revised downwards from the June *Inflation Report*, as a result of a higher interest rate and a stronger krone. Inflation was projected to reach 2½ per cent two years ahead. The effects of high wage growth on inflation were expected to be countered by the appreciation of the krone.

Norges Bank reviews the economic situation and the interest rate at the Executive Board's regular monetary policy meetings. The next monetary policy meeting is on 11 December. We will review recent developments and, as usual, undertake an overall assessment, which will be presented at the press conference following the meeting.