Challenges facing the Norwegian economy

Deputy Governor Jarle Bergo, Modum Sparebank, 2 December 2002

The text below may differ slightly from the actual presentation.

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Norway has a petroleum-based economy. Our petroleum revenues provide us with an economic starting point that many other countries do not have. How are we to live (well) with this petroleum? This question presents a number of challenges with respect to our economic policy.

Our petroleum wealth must be distributed across generations in an appropriate way. This means that the authorities must be disciplined and apply long-term considerations in their spending.

The flow of revenues from petroleum activities will vary. This may cause substantial variation in the demand directed at the Norwegian economy, and may amplify cyclical fluctuations. The use of petroleum revenues influences the competitiveness of Norwegian manufacturing. Large fluctuations in the use of revenues may have major consequences for the operating environment of internationally exposed industries. Therefore it is important that we succeed in maintaining an industry structure that promotes learning, innovation and development.

Petroleum activities constitute an important part of the Norwegian economy. In recent years petroleum revenues have amounted to 25-30 per cent of government income. A sound economic policy and high oil prices have contributed to the highest budget surpluses recorded in any OECD country. Even in 1998, when the oil price was down to USD 10 per barrel, we had a surplus of 4 per cent of GDP measured by government net lending.

The experiences of other countries show that an abundance of natural resources may be a mixed blessing. Societies that suddenly gain access to wealth have a tendency to spend the money and then fall into decline.

Access to an abundance of natural resources can result in slower growth. The explanation may be that time and resources are spent on seizing as large a share as possible of the wealth. Moreover, easy acquisition of wealth often erodes the incentive for innovation and work. The result will be a weakening of the internationally exposed sector. This is not conducive to the creation of value in the future, because a large exposed sector is more favourable for learning and development than a small one.

Historical experience therefore points to the importance of having a decision-making system as a safeguard against special interest groups acquiring a strong measure of control over the petroleum wealth. In addition we must maintain and develop incentives for acquiring new knowledge and engaging in innovative work. It is also important that we take up the question of wealth distribution across generations.

The most important part of Norway's national wealth is not the country's petroleum, but the value of its labour force. The substantial petroleum revenues now coming to us are not revenues in the usual sense, but the results of converting pre-existing petroleum wealth into financial wealth. Thus our petroleum revenues are not making us wealthier. A misconception of this kind could easily have a negative effect on our other wealth. Should our oil wealth lead to our working a little less, or being a little less productive, the decline in Norway's remaining wealth would rapidly become as great as our entire petroleum wealth.

On 29 March 2001, the Stoltenberg Government issued new guidelines for monetary policy and presented a guideline for fiscal policy. The fiscal policy guideline implies that, over time, the central government budget deficit shall be equivalent to the expected real return on the Government Petroleum Fund. The changes in the guidelines for economic policy received broad support in the Storting. The fiscal guideline was adhered to in the budget for 2002 and in the draft budget for 2003. Monetary policy was to be oriented towards low and stable inflation. The inflation target was set at 2½ per cent. The fiscal guideline implies that the non-oil deficit will increase in the years ahead. This will provide a stimulus each year. However, an unpredictable and more expansionary fiscal policy than that implied by the guidelines would have resulted in greater uncertainty.

To preserve the balance in the Norwegian economy, the phasing in of petroleum revenues must be offset by a tightening of monetary policy. This may be accomplished through a higher interest rate, an appreciation of the krone, or both.

There are high costs associated with high inflation. This increases uncertainty about future income and expenses among households and enterprises, and leads to unsound investments and wider fluctuations in the economy. It is also important to avoid deflation - falling prices - because this often accompanies and amplifies a downturn. Low and stable inflation provides households and enterprises with a clear indication of changes in relative prices. This makes it easier to make the right decisions and contributes to price stability in financial and property markets. This is the best contribution monetary policy can make to economic growth and stability.

We have had four periods of very high inflation over the past 100 years: 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. Inflation was a costly affair.

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.

History shows that higher growth and lower 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.

Furthermore, without a nominal anchor, employment and output will not move on a stable path. The economy must have a nominal anchor, and this is the task of monetary policy.

The Norwegian economy was without a nominal anchor under the policy of low interest rates and devaluations in the 1970s and ’80s. The fixed exchange rate regime, which was introduced in 1986, reinstated monetary policy as an instrument of economic policy in Norway and laid the foundation for more stable economic developments. With free flow of capital, deep capital markets and the phasing of petroleum revenues into the Norwegian economy, inflation targeting is the appropriate regime for setting interest rates.

Monetary policy is oriented towards low and stable inflation. The inflation target is set at 2½ per cent. In simplified form, we can say that the response pattern of monetary policy is: If evidence suggests that inflation will be higher than 2½ per cent with unchanged interest rates, the interest rate will be increased. If it appears that inflation will be lower than 2½ per cent with unchanged interest rates, the interest rate will be reduced.

Inflation in Norway is determined by both domestic and international inflationary impulses. Domestic inflationary impulses are influenced by the state of the Norwegian economy. International inflationary impulses are generated via prices for imported consumer and intermediate goods. These inflationary impulses will be influenced by developments in international commodity and consumer prices and by the exchange rate.

The impact of monetary policy occurs with considerable and variable lags. Our analyses indicate that a substantial share of the effects of an interest rate change will occur within two years. Two years is thus a reasonable time horizon for achieving the inflation target. It is nevertheless conceivable that in a situation where a very high rate of inflation is accompanied by sluggish economic growth, Norges Bank may decide to apply a somewhat longer time horizon than two years to reach the inflation target of 2½ per cent. The choice of monetary policy time horizon reflects the fact that there are real economic costs associated with bringing inflation rapidly back to the target. This horizon is thus an indirect expression of the trade-off between the objectives of, on the one hand, stable output, and on the other hand, low and stable inflation.

The inflation outlook for the next two years bears the marks of two opposing forces. On the one hand, high wage and cost inflation will keep prices for goods and services produced in Norway at a high level. On the other hand, the pass-through of the appreciation of the krone to prices will result in a temporary fall in prices for imported goods. If the krone exchange rate remains at the level of the last few months, the effect of the appreciation will be strongest towards mid-2003. The rise in the consumer price index adjusted for taxes and excluding energy products (CPI-ATE) is projected to slow down to 1¾ per cent next summer. Inflation is projected at 2½ per cent at the end of 2004.

The phasing in of petroleum revenues will have implications for Norway's industry structure. Increased spending of petroleum revenues on goods and services that are dependent on domestic resources requires an increase in employment in the sheltered sector. This labour has to be recruited from the exposed sector, or through the natural increase in the labour force finding its way to the sheltered sector.

We expect a considerable decline in manufacturing employment in the period ahead. One important reason for this is the deterioration in the competitiveness of Norwegian enterprises. In addition, the global economic situation has deteriorated. The slow rate of growth among our trading partners is affecting the markets of Norwegian exporters through lower demand and falling prices.

Productivity improvements will probably add to the effects of cyclical fluctuations and eroded competitiveness in reducing employment in manufacturing. In both Norway and other OECD countries, the manufacturing industry's share of overall employment has shown a trend reduction over the past 30 years.

From the first half of 2001 to the first half of 2002, the greatest change in manufacturing employent has taken place in the engineering and transport equipment industries. In these two sectors alone, employment rose by 2400 persons from the first half of 2001 to the first half of 2002. In the processing sector, the basic metals and pulp and paper industries experienced the largest decline of in all 1200 persons.

The decline in manufacturing employment is not confined solely to Norway. A trend decline is evident worldwide. The scaling back is taking place at different rates, and has different consequences from one country to the next. The US has experienced the sharpest decline in industrial employment, measured as a share of total employment.

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. This has had consequences for the profitability of internationally exposed industries. 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.

We have gained costly experience from previous developments of this type. In both the mid-1970s and the mid-1980s, the Norwegian business cycle diverged from that of trading partners. In the periods 1975-1978 and 1982-1988, wage growth in Norway was markedly higher than wage growth among trading partners. The consequence of this trend was a severe deterioration of the competitiveness of exposed sector businesses. In both periods, it resulted in an economic downturn with low real wage growth and higher unemployment, also in sheltered industries. This is a mechanism that can be expected to operate again.

Cyclical divergence between Norway and other countries is reflected in the interest rate differentials between Norway and both Germany and the US. Interest rates internationally are very low today, in order to counteract the downturn.

The large interest rate differential has contributed to an appreciation of the krone. In addition, the sharp fall in share prices worldwide has led to a focus on "safe" investments. The Norwegian krone, with a relatively high interest rate backed by Norway's oil wealth, may be an attractive option. The krone has appreciated by 15-20 per cent against the currencies of our most important trading partners since the summer of 2000, thereby eroding the competitiveness of Norwegian manufacturing even further.

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.

The international downturn has also weakened the sales prospects of many export industries. There is less demand for Norwegian manufacturing products, and falling prices for important export goods. The global situation is unclear. Growth may pick up again, but it is uncertain when the turnaround will begin. Norwegian manufacturing must be prepared for demand to remain weak in the time ahead.

Even if employment and output in the Norwegian manufacturing industry are scaled back, developments for Norwegian enterprises may not necessarily be negative. Some enterprises may be at the cutting edge of technology, and increase their efficiency in pace with the rise of costs in Norway. Labour-intensive activities can be located abroad. However, the scaling back of manufacturing involves a risk. It makes the economy more vulnerable; the foundation for learning, innovation and development may be undermined unless the business sector is exposed to intensive international competition.

It should be possible for us to live well with petroleum, but it will require our addressing a number of challenges. We must distribute our petroleum wealth across generations in an appropriate way. The varying inflow of revenues must be managed so that we avoid generating unnecessary fluctuations in the economy and in competitiveness. At the same time, using our petroleum revenues implies a deterioration of our competitiveness. It is therefore very important that we succeed in maintaining an industry structure that promotes learning, innovation and development.