The economic situation in Norway

"Diplomatforedraget" - address by Governor Svein Gjedrem to invited foreign embassy representatives, Norges Bank, Thursday, 30 March 2000

Your Excellencies, ladies and gentlemen

In my address to you last year, I highlighted a turnaround in the Norwegian economy. After six years of strong growth with increasing imbalances in the economy, the fall in oil prices, the international financial crisis and slower growth in the world economy led to a period of sluggish growth. In Norges Bank's view, there was a risk of a deflationary recession.

In fact, this particular risk would now seem less prominent. At this time last year, oil prices stood at USD 10 a barrel. At present, oil prices are USD 24 a barrel, after having hovered around USD 30 a barrel for a while. The period of sluggish growth now appears to be transient. European economies are expanding while the US economy is still booming. Even after a year of slower growth, economic activity in Norway is still high.

In my speech here today, my focus will be on explaining special aspects of the Norwegian economy, which is largely based on a limited number of commodities. I shall discuss the importance of the petroleum sector and the challenges associated with volatile oil prices. Then I will give you a historical overview of monetary policy in Norway over the last 30 years. Against this background, I will try to explain how we conduct monetary policy today and give you our latest assessment of the prospects for the Norwegian economy.

The importance of the petroleum sector

Extraction of North Sea oil started in the 1970s, and the production volume has increased over the years. The petroleum sector employs only a small part of the total labour force, but brings in substantial revenues. A main challenge to Norwegian economic policy is therefore to stabilise the Norwegian economy in the face of high, fluctuating petroleum revenues.

Some figures will illustrate the importance of the petroleum sector in the Norwegian economy.

Given the current estimates for existing resources, production is expected to be at its maximum between 2000 and 2010. It is then expected to decrease gradually as the remaining resources are reduced. The future level of oil production is highly uncertain.

Employment in the petroleum sector and related industries is only around 4 per cent of total employment. Investment in the petroleum sector has been substantial compared to investment in the rest of the economy, and as a share of GDP. Investment accounts for an import share of about 1/3. This means that investment relating to the petroleum sector has had a substantial effect on industries in mainland Norway.

The petroleum sector is an important source of revenues for the government, both through taxes and through direct government ownership.

Projections indicate that revenues will remain at about the same level until around 2008, when they are expected to decrease gradually as petroleum production declines.

The Norwegian government is running a budget surplus including petroleum revenues.

The columns show the budget surplus (or deficit), excluding petroleum revenues. The line represents total net government surplus, which is transferred to the Government Petroleum Fund. The surplus also includes returns on Fund investments. We note that the amount of petroleum income used to finance public expenditure varies from year to year, while a large portion of the income is saved.

Oil prices and hence petroleum revenues fluctuate over time.

After a period of high prices in the 1970s, when OPEC first demonstrated its power, and the early 1980s, oil prices have been fairly stable.

Focusing on the last 15 years, somewhat larger fluctuations have been observed since 1997. In 1998 the price of oil dropped temporarily below USD 10 a barrel. Last year the price increased substantially above the USD 15 to USD 17 a barrel price range that we consider a more "normal" level. Today, the price is around USD 24 a barrel.

Fluctuating oil prices and economic stability: Dutch disease and the Government Petroleum Fund

Oil revenues increase consumption potential. However, it is a challenge to manage these resources in a way that increases welfare for current and future generations.

A rapid expansion of the sheltered sector based on uncertain and perhaps temporary increases in petroleum revenues may lead to the situation called Dutch disease.

The impact of oil price fluctuations on the exchange rate and on economic stability in general will depend on the speed at which petroleum revenues are used. In general, income can either be used now, or saved by accumulating assets abroad, so as to redistribute the income and thus consumption between generations. If petroleum revenues are to be used for increased sheltered goods consumption, such as services like health care and education, a real exchange rate appreciation, that is, a loss of competitiveness, will be needed to initiate the reallocation of resources to the sheltered sector. The extent of the reallocation will depend on how fast the revenues are used and how much is saved for future consumption.

Suppose, as one extreme, that all government budget revenues were used in that same period. This means that an increase in the oil price would increase government revenues and domestic demand, encouraging a reallocation of resources from the exposed to the sheltered sector. If the oil price fell again later, Norway would be left with an exposed sector that is too small, resulting in a current account deficit and expectations of an exchange rate depreciation that would be needed to restore the exposed sector.

Such fluctuations in the use of oil revenues would lead to considerable instability in the Norwegian economy and large fluctuations in the exchange rate over time. Norwegian economic policy is organised to counteract such instability.

The key issue is to prevent increased petroleum revenues from leading directly to increased government consumption, in other words to reduce the dependence of government spending on oil revenues. The share of government spending financed by oil revenues varies over the business cycle. For the past few years this share has averaged around 3 per cent, and it is expected to be kept at about that level over the coming years.

To this end, Norway has created the Government Petroleum Fund. The Fund receives revenues from the petroleum sector, transfers the amount necessary to produce a balanced government budget and invests the surplus abroad. As long as the increase in petroleum income is kept outside the domestic economy, there will be less need for structural change and thus less need for exchange rates to change.

The Petroleum Fund serves many purposes. It is a means of storing wealth and redistributing income from oil extraction between generations, of buffering against changes in oil prices, and of facilitating demand management. Thus, the Fund facilitates the fiscal policy tasks of maintaining the desired size of the exposed sector and stabilising the economy.

Historical perspective

Let me now give you a longer term perspective to how the petroleum sector has impacted on the Norwegian economy and at the same time give you a background for monetary policy in Norway today.

The post-war fixed exchange rate system - the Bretton Woods System - collapsed in 1971. A few years later, the Yom Kippur War broke out and OPEC countries suspended oil deliveries, triggering the first oil crisis. The sharp rise in oil prices led to a recession in the western economies. Moreover, inflation took root in most countries. In Europe, only Germany and Switzerland were able to keep inflation more or less at bay.

In Norway, the welfare state and support schemes for businesses were rapidly expanded partly based on expectations of large future oil revenues. Furthermore, economic policy was oriented towards building a bridge over what was expected to be a temporary downturn in the world economy. This led to a tug of war for real resources between the business sector and the public sector - between the exposed and the sheltered sector. The cost level in manufacturing industry was driven upwards and competitiveness detoriated.

Two forces were behind economic developments from the beginning of the 1970s. First, the deterioration in competitiveness was caused by the expansion of the Norwegian welfare state and a transfer of real resources from the exposed sector to the sheltered sector. Second, inflation expectations took root as a result of low administered interest rates and competitive devaluations. Nominal interest rates were kept low although price inflation and the value of tax-deductible interest expenses rose. Frequent devaluations in the period from 1976 were ultimately ineffective with regard to preventing a relative decline in manufacturing industry. On the contrary, the devaluations proved to be self-reinforcing.

This chart proves the point. It shows consumer prices in Norway compared with consumer prices in Germany and the value of NOK against DEM since 1970. Over a period of 15 years from 1973 to 1988 consumer prices in Norway rose twice as much as in Germany. In the same period, the value of the krone was virtually halved against the Mark.

While we paid around 2 kroner for one Mark in 1973, 15 years later we had to pay close to 4 kroner. Since then the krone has remained relatively stable against the Deutsche Mark. Today the exchange rate is around 4 kroner and 15 øre.

The last devaluation came in 1986 after the fall in oil prices. Thereafter, the krone exchange rate was fixed. The Norwegian economy had to go through a severe economic turnaround. Confidence in the krone had to be restored in order to avoid persistent inflation. This required very high interest rates. The Norwegian economy entered the worst recession experienced since the interwar period. Unemployment rose from about 2 per cent in 1987 to almost 6 per cent in the winter of 1992/1993. Many companies went broke and households were faced with debt problems. The financial sector was hit by crisis.

The fixed exchange rate regime led to a gradual decline in price inflation, but not to deflation as was the case in Norway as well as in many other countries in the 1920s.

An improved wage-setting process, in conjunction with an active fiscal policy, contributed to curbing the real economic costs. Hence, the experience of 1986 and the beginning of the 1990s probably provides a realistic picture of the minimal costs associated with stamping out high inflation.

In Norway, high inflation has been a war phenomenon and a phenomenon of the 1970s and 1980s. In the aftermath of high inflation, we experienced substantial real economic losses and financial instability. The cost of inflation has been high.

History shows that lower unemployment cannot be achieved in exchange for higher inflation in the long run. A monetary policy that fuels inflation does not generate economic growth. On the contrary, the result is booms and speculative bubbles, which are the precursors of recession and unemployment.

In the absence of nominal stability, employment and production will not show stability either. The economy must be endowed with a nominal anchor. This is the task of monetary policy.

The Norwegian economy was lacking a nominal anchor during the period of low interest rates and devaluations in the 1970s and 1980s. This led to rising inflation and instability. From 1986 the fixed exchange rate regime restored confidence in monetary policy and subsequently laid a foundation for more stable economic developments.

Through the 1990s, inflation has been on a par with or below inflation in Europe. While the average annual rise in prices was a good 8 per cent in Norway in the 1970s and 1980s, the annual rise in consumer prices has been confined to 2¼ per cent in the 1990s. The subdued rate of increase in consumer prices has coincided with a strong expansion. In 1999, the number of employed was 10 per cent higher than in 1990.

We had to abandon our fixed exchange rate policy in December 1992, primarily as a result of the system's inherent weaknesses in a world of free flows of capital and deep international financial markets. When the fixed exchange rate policy was formally abandoned, there was a risk that the Norwegian economy would again lose its nominal anchor. However, the krone exchange rate showed little change and quickly found a new trading range.

In the first years after the fixed exchange rate regime was abandoned in 1992, the krone exchange rate was very stable, also on a daily basis. When we now look back at developments in the Norwegian foreign exchange market in the 1990s, we see no significant change in 1992. On the contrary, we witnessed a pronounced shift in January 1997. It was from this point in time that daily quotations and month-to-month variations in the exchange rate show that the krone is floating.

In 1996 and in the autumn of 1998, Norges Bank attempted to reduce movements in the krone exchange rate through exchange market interventions. On both occasions, interventions prompted a game situation between the central bank and market participants, as was also the case during the currency crisis in the autumn of 1992. When a central bank trades its own currency, market operators make a play for profits on the premise that the exchange rate does not reflect market fundamentals. In a world where capital flows freely, this game situation can quickly trigger large capital movements. The experience of the 1990s shows that Norges Bank does not have the instruments to fine-tune the krone exchange rate.

Today's monetary policy

The objective of monetary policy is exchange rate stability against European currencies, defined as the euro from 1 January 1999. Norges Bank's mandate - which is the Exchange Rate Regulation - takes into account that the krone may remain outside its normal range.

The Exchange Rate Regulation states that "in the event of significant changes in the exchange rate, monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range". The concept "significant changes" is not quantified and must be given an economic content. Norges Bank interprets a "significant" change in the exchange rate as a change that fuels expectations of price and cost inflation to the extent that the change in the exchange rate becomes self-reinforcing.

Monetary policy can counter such a self-reinforcing movement in the exchange rate by contributing to low and stable inflation without recession.

In its conduct of monetary policy, Norges Bank therefore places emphasis on fulfilling the fundamental preconditions for exchange rate stability against the euro: Monetary policy instruments must be oriented towards bringing inflation down to the level aimed at by the Eurosystem. At the same time, Norges Bank must prevent monetary policy from contributing to a deflationary recession as this may weaken confidence in the krone.

Fiscal policy and the Government Petroleum Fund have proved to be effective in terms of sheltering the mainland economy from more normal variations in oil revenues. A permanent change in the krone exchange rate will occur if there is an increase in the use of oil revenues through a shift in expenditure growth. In this context, instruments other than those available to Norges Bank must be used to return the krone to its initial range.

Over the last 15 years, the business cycle in Norway has differed from the cycles in most European countries. The output gap provides a rough indication of the phase of the business cycle. The chart shows a specifically Norwegian upturn in the mid-1980s and a subsequent downturn. While the downturn bottomed out in Norway in 1990, other European economies were booming. Subsequently, the business cycles have remained different. The economic fluctuations in Norway can to some extent be traced back to the disturbances in the Norwegian economy in the 1980s and the economic shock in Europe in the wake of the fall of the Berlin Wall.

The divergence in business cycles is the main reason behind the inflation differential between Norway and euro area countries. The very low rate of inflation in Europe primarily reflects the downturn in the 1990s. A fundamental precondition for exchange rate stability against the euro is that the inflation rate in Norway is brought down to the level aimed at by the Eurosystem. In recent years, the rate of increase in prices has been higher in Norway than among euro area countries, which is reflected in the interest rate differential between Norway and the euro area.

The economic situation

Signs of an overheating of the Norwegian economy, with a sharp increase in wage growth, low oil prices and international financial turbulence, contributed to a marked depreciation of the krone exchange rate in mid-1998. In an environment of strong pressures in the economy, there was a risk of a self-reinforcing depreciation of the krone. In response to these developments, Norges Bank raised its key rates by a considerable margin in the period to end-August 1998. When the euro was introduced as a common currency in the 11 euro area countries on 1 January 1999, the krone stood at 8.86 against the euro. At the same time, the three-month money market rate in Norway was 8 per cent, or 4.5 percentage points higher than the level in the euro area.

The high level of interest rates in the latter half of 1998 and a tight central government budget for 1999 dampened the pressures in the economy. At the same time, the growth prospects for the international economy were weak.

At the beginning of 1999, the outlook for the Norwegian economy implied a reduction in price and cost inflation over the following years to the level aimed at by the euro area. Furthermore, Norges Bank's analyses pointed to a risk of a downturn that could weaken confidence in the krone. The objective of exchange rate stability over time thus implied that it was appropriate to reduce interest rates.

In the course of 1999, Norges Bank lowered its key rates from 8 percent to 5½ per in five steps. There was a marked appreciation of the krone exchange rate in the same period.

Norges Bank has left its key rates unchanged since September 1999. One week ago Norges Bank published its most recent analysis of the outlook for the Norwegian economy in our Inflation Report for the first quarter. Our analyses indicate that the current consolidation in the Norwegian economy, after a decade of strong growth, may be less painful than expected earlier.

Developments in 1999 indicate that the slowdown in the Norwegian economy came to an end last summer. With the exception of fixed investment in the petroleum sector, all demand components exhibited an upward movement in the second half of last year.

A number of indicators point to higher growth in private consumption in recent months.

Retail sales and credit growth are rising. House prices continue to drift up. Normally, higher house prices lead to lower saving and higher private consumption.

Households are increasingly optimistic about their financial position and the economic prospects for Norway. Norsk Gallup's consumer confidence indicator continued to rise in February, reaching its highest level since the summer of 1998 when interest rates were increased. This consumer confidence indicator usually provides a good indication of movements in private consumption.

The growth outlook for trading partners has improved. Growth in the world economy recovered relatively quickly after the crisis in the autumn of 1998. The chart shows forecasts for global GDP growth in 2000 at various points in time. Economic developments in the crisis-hit countries in Asia were reversed more quickly than anticipated. At the same time, the long period of expansion in the US has continued, and growth rates in Europe have continued to rise.

Traditional merchandise exports have increased in recent months, reflecting higher growth in the global economy. Estimates for export growth have been revised upwards. Oil prices have more than doubled compared with the same period last year. A year ago, our estimate of the current account surplus for this year was around 2 per cent of GDP. Now, our estimate is 11 per cent of GDP, or NOK 150 billion.

Business investment is expected to continue to make a negative contribution to growth this year. But the fall in investment is now estimated to be more moderate than earlier projected. This, combined with improved global economic prospects and expectations of higher consumer demand, has led us to raise the forecast for mainland GDP growth to 1½ % in 2000 and 2% in 2001. While fairly moderate, these forecasts are considerably higher than envisaged one year ago.

Pressures in the labour market remain strong. So far, the contraction in manufacturing has been more than offset by continued high employment growth in the public and private service sectors. Against the background of an upward revision of output growth this year and next, the turnaround in the labour market is now expected to be less pronounced than earlier projected. Our estimates point to a very moderate rise in unemployment from 3½ per cent this year to around 3¾ per cent in 2001 and 2002.

The risk of a downturn in the economy now appears to be limited. The risk of rising price and cost inflation has increased. In the light of recent economic trends and the balance of risks, the probability that the next change in interest rates will be an increase is greater than the probability of a reduction.

Conclusions

Let me conclude by summing up as follows.

The Norwegian economy is highly dependent upon a few basic commodities, of which oil and gas naturally are the most important. Oil prices and revenues from the petroleum sector vary. We must learn to live with that. To this end, Norway has created the Government Petroleum Fund, which serves among other things as a buffer against changes in oil prices. Since investing the surplus abroad, the domestic economy is more or less sheltered from fluctuating oil prices. The Fund therefore also supports monetary policy in Norway, by helping to keep the exchange rate stable.

The period of sluggish growth envisaged last year seems to be over. Our latest projections indicate that economic growth will pick up to more normal levels in one or two years. The pressure in the economy is still high. Norges Bank must therefore use the means necessary to secure stable economic developments, thereby stabilising the krone exchange rate.

Thank you for your attention.
I will now be happy to answer any questions you may have.