The economic outlook

Speech by Governor Øystein Olsen to invited foreign embassy representatives, Norges Bank.

The speech is based on the annual address 2013, Monetary Policy Report 1/13 and previous speeches. Please note that the text below may differ slightly from the actual presentation.

Excellencies, Ladies and Gentlemen,

First of all, I would like to welcome you to Norges Bank.

Five years after the financial crisis started, growth is weak and unemployment high in many countries. The economic situation in Norway stands in contrast to developments abroad. Norway's economy is still growing and unemployment remains low. There is a tendency to see ourselves as a country apart.

Truly, Norway's oil and gas resources provide an economic base that few other countries enjoy. Income levels are among the highest in the world. At the same time, our increasing dependence on oil and gas increases the vulnerability of the Norwegian economy.

The theme of my presentation today is how to enhance the resilience of the Norwegian economy.

When the financial crisis washed over the Norwegian banking sector in autumn 2008, we were reminded of how dependent we are on the world around us. Nonetheless, the Norwegian economy weathered the crisis well. After about a year, the downturn in Norway was over.

Chart 1: Emerging economies are driving oil demand

One of the main reasons is the strong demand for Norwegian goods in countries where economic growth remains robust. The centre of gravity in the world economy is shifting. In the course of the next few decades, China will most likely be the largest economy in the world. Emerging economies – with China at the forefront – are the main driving force behind the increase in demand for crude oil and other commodities. As a result, prices for Norwegian export goods have remained high, even in the context of declining growth among our traditional trading partners.

Chart 2: Strong improvement in terms of trade

The emergence of newly industrialised economies has also led to lower import prices in Norway. The improvement in Norway's terms of trade is without parallel in our recent history. We have to go back to the boom period at the time of World War I to find anything similar.

Developments in other countries have been less favourable. What started as a banking crisis in the US and the UK has developed into a sovereign debt crisis, with Europe at the epicentre. Austerity measures and economic contraction are now going hand in hand. Social unrest is spreading.

Unemployment in many countries has risen to alarming levels. Economic growth is weak, particularly in Europe, constrained by uncertainty and fear of new setbacks. Both the public and private sectors are focusing on reducing debt. Banks are consolidating their balance sheets and holding back on lending to businesses and households.

Chart 3: Public debt – highest since WWII

Total sovereign debt in advanced economies is almost as high as it was after World War II, following a period of soaring, debt-financed military spending. The long post-war boom helped to reduce debt.

Experience shows that it is difficult to restore growth after a financial crisis. Necessary austerity measures can amplify an economic downturn, with falling tax revenues and rising spending on benefits, trapping both public finances and economic activity in a downward spiral. This is what we have seen in Europe.

Today, economic growth is low in virtually the entire OECD area. Many countries are forced to implement fiscal consolidation measures, while there is also a need to stimulate the economy and create jobs. That is a difficult balancing act.

Chart 4: Euro area crisis – less fear

The European crisis was acute about a year ago, at the beginning of 2012. Spanish and Italian government bond yields had risen markedly. The reason was not only the uncertainty related to sovereign debt problems in those countries. Markets also reflected fears that the construction – European monetary union – might crumble. The question of the fate of the euro was on the table.

Through 2012, the European Central Bank (ECB) intervened with resolute measures to calm the markets. The banking system was offered large amounts of long-term funding. In summer 2012, the ECB declared that it was prepared to make unlimited purchases of government debt which fulfill the conditions for borrowing from the European Stability Fund.

These measures seem to be working.

Borrowing rates for debt-burdened countries have fallen markedly. Other risk premiums have also decreased. Fears of a euro-area breakup and the collapse of the European economy no longer seem dominant.

The European monetary union – after being established – cannot be dissolved without serious consequences for Europe and the world economy. There is little point in discussing whether the original idea was a good one or not. The child was born and is now a teenager.

As expected, puberty has presented problems. These problems must now be dealt with by the European authorities.

Budget deficits in Europe are being reduced, despite strong headwinds from the slowdown that follows in the footsteps of austerity. Structural reforms are being implemented to increase growth capacity over time. Business sector costs are falling and competitiveness is improving in the countries hardest hit by the crisis. Steps have been taken in the direction of closer cooperation and coordination of economic policy.

However, the path ahead is long. We may have to wait until the next decade before growth gains a firm footing in Europe.

Nonetheless, we have seen a clear shift in financial market sentiment. This shift is reflected in the fall in European government bond yields. The clearest indication of optimism can be found in equity markets.

Chart 5: Government Pension Fund Global

With the upswing in equity markets, the value of Norway's financial wealth is increasing. Close to 60 percent of the capital in the Government Pension Fund Global – Norway's sovereign wealth fund – is invested in global equity markets. In times of good growth in the global economy and when optimism is on the rise, the return on the Fund increases. Conversely, turbulence and low risk willingness in the market have a negative effect on the Fund's assets. This is a risk we have to live with to achieve solid returns over time.

Because of the Fund's long-term horizon, short-term risk tolerance is high. We can exploit this by engaging in countercyclical investment. The Fund's size also allows us to reduce risk by spreading our investments across many countries. Norway has become a global financial investor. Through the Fund's investments, Norway increasingly takes part in value added generated in other countries.

Over the past hundred years, growing global trade and cross-border flows of capital and labour have been important factors driving economic progress. At times, the principles of free trade and capital movements have been set out of play. Walls have been raised between countries in the form of trade barriers and restrictions on capital flows. This has not been successful. Countries that have attempted to shield their economies from the rest of the world have fallen back into stagnation.

Growing signs of increased protectionism are again causing concern. If this tendency intensifies, international trade and prosperity will be undermined. With its open economy, Norway would be severely affected. It is in our own interest to make active efforts to counteract such a development.

Monetary policy – a nominal anchor

Against the background of an economic downturn and low interest rates among Norway's trading partners, the conduct of monetary policy in Norway is challenging. A higher key policy rate might have curbed debt growth and demand pressures in the Norwegian economy. But in an environment of persistently low external interest rates, such a policy would likely have led to a sharp appreciation of the krone, resulting in too low levels of inflation and economic activity. Thus, the crisis in Europe and weak growth in the US are also contributing to keeping interest rates in Norway at a low level.

The main objective of monetary policy in Norway is low and stable inflation. This objective provides the economy with a nominal anchor. With firmly anchored inflation expectations, monetary policy can contribute to stable developments in the real economy.

Chart 6: Rise in consumer prices

The operational target of monetary policy is annual consumer price inflation of close to 2.5 percent over time. Over the past ten years, average inflation has been somewhat below, but close to, 2.5 percent.

A credible and firmly anchored monetary policy can contribute to curb the impacts of external shocks. This increases the resilience of the Norwegian economy.

More resilient banking sector

The financial crisis provided us with some important insights. First, the crisis illustrated that low and stable inflation is not sufficient to secure financial stability. Second, the crisis revealed severe shortcomings in banking regulation. Banking and financial sector regulation is now being reformed in many countries.

Norwegian banks have become more solid in recent years. This is a positive development. Banks' capital, in particular that of the largest banks, should be increased further in order to satisfy the new regulations.

The forthcoming regulatory framework for banks in the EEA includes a countercyclical buffer – a capital requirement that can be increased in upturns and turned off in downturns. When banks are required to build up an additional buffer, they are better equipped to cope with periods of rising losses.

The buffer will strengthen the resilience of the banking sector during an upturn. It may also counteract the build-up of financial imbalances, although the effect is uncertain. Thus, Norges Bank cannot disregard taking financial imbalances into consideration when setting the key policy rate. The criteria for the conduct of monetary policy remain firm, also after the introduction of a countercyclical capital buffer.

Later this year, Norges Bank will provide advice to The Ministry of Finance on the size of the countercyclical buffer. An integrated analysis and set of forecasts form a common basis, both for this advice, and for the Bank's monetary policy decisions.

The Norwegian economy is also vulnerable

Structural adjustment in the business sector is the key to economic progress. Over the past 40 years, the oil and gas industry has been an engine of innovation and growth in Norway. In the beginning phases of the Norwegian oil age, the impulses to other economic sectors were modest. Over the years, we have developed an internationally competitive petroleum supply industry of considerable scope.

While the companies operating on the Norwegian continental shelf had to import virtually all their equipment in the 1970s, the import share has now dropped to just below 40 percent. The Norwegian engineering industry has flourished. The supply industry has become a major export industry. Almost two-thirds of total Norwegian exports are now linked to the petroleum industry.

Chart 7: Divergence in manufacturing

Vigorous activity in the oil and gas industry helped Norwegian manufacturing sectors during the financial crisis. The petroleum industry is a buffer against the current downturn in advanced economies. In that respect, the Norwegian economy has become more robust.

The flip side of the coin is that our economic future is becoming increasingly dependent on oil and gas activities. The substantial petroleum revenues and the spillover effects from oil and gas production are reflected in the labour market and are driving up house prices and debt. Thus, the Norwegian economy is also vulnerable.

In the mid-1980s, the Norwegian economy was shaken by a sharp and long-lasting fall in oil prices. Today's situation is quite different. Oil prices are persistently high, reflecting the emergence of newly industrialised countries. But it is risky business to take today's oil price levels for granted. New energy technologies are being developed. Climate challenges will not disappear. If oil prices were to fall again, a number of off-shore investment projects would become unprofitable, with considerable spillover effects on other sectors of our economy. Unemployment in Norway would probably rise. We cannot eliminate that risk. Curbing the exploitation of oil and gas resources is not a feasible alternative. The abiding question is rather how to limit the vulnerability associated with increased oil dependence.

The fiscal rule for petroleum revenue spending is an important buffer. The petroleum fund mechanism and moderate and predictable spending of petroleum revenues over the central government budget contributes to enhancing economic stability. Reserves accumulated in the Government Pension Fund Global provide fiscal leeway in the event of an economic setback, as observed in 2008 and 2009.

By limiting petroleum revenue spending to the expected real return on the Fund, we ensure that our petroleum wealth will benefit future generations. A balanced approach to revenue spending will allow future generations to benefit from what is spent on public investments domestically.

Chart 8: Norwegian labour is expensive

The spending of petroleum revenues also has another facet. It increases the cost of Norwegian labour. During upturns Norwegian companies have fared well, in spite of rapidly rising costs, thanks to efficiency gains and rising producer prices. Some other countries in Europe allowed costs to rise at broadly the same pace over a number of years. Now these countries are in a downturn with a high level of spare capacity, and with a need to improve competitiveness.

Should the outlook for the petroleum industry show a significant shift, Norway will have to start down the hard path of economic adjustment. The high level of costs in our country may become a hindrance in the competition for tenders and market shares. What we need above all is a profitable and efficient business sector that can adapt to new times. In that respect, there are some aspects of the Norwegian economy that give cause for reflection.

Chart 9: Mainland GDP – stable nominal growth

On the surface, developments are positive. Nominal mainland GDP growth at current prices has been surprisingly stable. Over the past 20 years, nominal mainland GDP has increased by around 6 percent annually, and growth is still hovering around that trend. There were some tendencies towards overheating in the years prior to the financial crisis. But the correction that followed during and after the crisis has brought growth back to trend. There is little in this chart to indicate that the world economy has recently been through the most severe economic downturn in post-war history.

The picture changes when growth is broken down into price and volume. As mentioned, high prices for domestically produced goods have supported our country's income. Since 2005, producer prices have increased considerably faster than trend. This illustrates that mainland businesses have also benefited from the substantial improvement in Norway's terms of trade.

Chart 10: Mainland GDP – slump in economic activity

Economic activity, on the other hand, slumped during the financial crisis. Although economic growth has picked up in the past few years, the level is still well below the pre-crisis trend. This could indicate that the financial crisis and the debt crisis have had lasting effects on the Norwegian economy as well.

Chart 11: Mainland GDP – per capita

The picture becomes even clearer when population growth is taken into account. Measured per capita, we do not generate more value today than we did five years ago. This picture is similar to that of other advanced economies. The break from the years prior to the financial crisis is clear. Growth is being supported by immigration and employment growth, not by increased productivity.

There are two factors that determine value added and prosperity in a population. One is labour input and the other is labour productivity. I will look at some aspects of each of these factors.

Chart 12: Employment ratio is high, but hours worked are low

The employment ratio is high in Norway. Labour force participation is high and most job-seekers find work.

Employment has increased rapidly since the mid-1990s. An expansionary monetary policy and additional government expenditure of oil money stimulated activity and employment through the financial crisis. Measured by hours worked, labour input has also risen, albeit not to the same extent. On average, the working day is shrinking.

The employment ratio adjusted for working hours provides an expression of average labour input per hour worked among the active population. In this chart, hourly labour input is measured in relation to usual hours of work per year of 1 750 hours. In 2011, the average number of hours worked in Norway was about 60 percent of usual hours of work per year. By this measure, the employment ratio this year was higher in Greece than in Norway. Total labour input is considerably higher in Sweden, Finland and the US than in Norway. We work less than the OECD average.

When income growth is high, it is natural that some of the increased wealth will be reflected in a greater demand for leisure. It is nevertheless telling that the number of hours actually worked is considerably lower in Norway than among our main trading partners, despite very low unemployment in Norway. Generous transfer schemes and other aspects of our welfare system induce many to exit the labour force – completely or partially. In recent years, the high level of labour immigration has compensated for this. Nonetheless, this situation does not seem sustainable. Reforms that provide stronger work incentives are needed and should be implemented in anticipation of an ageing population. The pension reform was an important step in the right direction.

Chart 13: Productivity growth has declined

What about the other factor that is crucial to growth? Mainland productivity increased markedly in the 1990s, partly owing to a number of structural reforms. The banking sector was rationalised after the crisis. The tax reform set the stage for profitable investments and business sector restructuring. Improved competitiveness and the development of the oil industry facilitated the rapid integration of new technology by firms. Productivity growth remained relatively high up to around 2005. But since then it has declined. The decline has been more pronounced than among our trading partners.

Chart 14: High employment growth in labour-intensive sectors

The phasing-in of a highly profitable oil industry and higher petroleum revenue spending via the central government budget has amplified the structural shifts in the Norwegian economy. Services production has increased. When the financial crisis hit, industries that do not benefit from oil sector demand or public spending stagnated. The differences in growth across industries has thus widened since 2008.

Labour-intensive sectors with relatively low productivity have accounted for a large share of employment growth in recent years. Employment has shown only moderate growth in industries with a high productivity level, such as manufacturing and engineering.

Productivity growth has stagnated in most OECD countries. Goods production has declined, while services production has increased, as in Norway. In many countries this shift was based on borrowing rather than increased earnings. After the financial crisis, funding sources dried up and these countries were faced with a debt crisis. Fundamental structural problems with eroded competitiveness came into evidence. These countries must not only reduce their debt levels, but also engage in a painful process of structural adjustment. Only then can these economies find the path to renewed growth.

The Norwegian economy has experienced virtually 20 consecutive years of growth. We have invested in a profitable oil industry and found a balance between spending petroleum revenues domestically and saving petroleum revenues. On the other hand, it seems that both the public and private sectors are having difficulties finding profitable mainland investment projects. Taking a longer view, this is a source of concern. Should petroleum revenues shrink, our economy needs more pillars to stand on. Otherwise, we as well would have to embark on a path of adjustment towards renewed growth.

Perhaps Norway is not so much an economy apart after all.

Thank you for your attention.