

Monetary policy from the perspective of a commodity-exporting country

Dinner speech by Governor Øystein Olsen at the European Central Bank in Frankfurt.

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

I would like to thank the ECB for hosting this conference on a topic that is a core interest for us in Norges Bank. It is a pleasure to visit the ECB in Frankfurt. In my remarks tonight, I will give you a glimpse into the historical background for our economic framework and the conduct of monetary policy in Norway today.

As you know, Norway is in the fortunate position of having ownership rights to large natural resources. Oil was discovered in the North Sea in 1969. Back then, it soon became clear that oil and gas would be a source of substantial wealth – and government expenditure and social programmes expanded rapidly.

By 1977, a surplus on the current account had turned into a deficit of 12 percent of GDP. The deficit was three times larger than that of Italy and Spain last year. Predictably, we also experienced a contraction in the non-oil tradable sector. Fiscal policy had fuelled a boom-bust economy and had to be reversed and tightened. Many Norwegians experienced a decline in real income.

When oil prices fell in 1986, the Norwegian economy was hit again. We experienced a collapse in house prices, as well as a severe banking crisis, a foreign exchange crisis, fiscal deficits and high inflation. Hermod Skånland, the Norwegian central bank governor at that time, summarised the causes of the crisis as "bad banking, bad policy and bad luck."

Efforts were now focused on bringing public spending under control, while large parts of the banking system were nationalised. Unemployment soared. Monetary policy aimed at a stable krone exchange rate, resulting in high real interest rates. But with a binding commitment to a fixed exchange rate, inflation was brought under control.

The banking crisis and the downturn in the early 1990s made clear how vulnerable our small open economy was to terms-of-trade shocks and that our banks needed to be properly regulated. Furthermore, it became evident to policymakers how hard it is to conduct countercyclical economic policy, or even to avoid being procyclical.

In the following years, structural reforms were implemented in order to increase growth capacity, including a major general tax reform. The tax code had already been tailored to capture the economic rent in the petroleum sector – the petroleum company tax rate is about 80 percent. Confidence in monetary policy gradually gained a firmer footing, after a succession of devaluations had come to a halt. Inflation and the real interest rate declined, and cost competitiveness improved considerably.

Norway has not experienced a really pronounced economic downturn since the crisis around 1990. We have been helped by good luck, in terms of favourable terms-of-trade shocks and a relatively flexible labour market, which has allowed labour supply to grow. The economy was fairly robust when the financial crisis hit in 2008, in sharp contrast to our situation back in the 1980s. A more robust policy framework has improved the functioning of the economy.

The Act relating to the Government Petroleum Fund was passed in 1990. At the time, in the midst of a deep recession, many doubted that any petroleum revenues would ever be saved. Projections indicated that offshore petroleum production would peak in the early 1990s. However, the government's cash flow from the petroleum sector started to increase sharply, and a strategy for the management of the fund was needed. The policy guidelines were clarified in 2001, and rules governing the interaction between Norway's petroleum wealth and fiscal policy were established:

- All government revenues from the oil sector are to be transferred to the fund.
- According to the fiscal rule, the government must only spend, on average over the cycle, the expected real return on the fund – stipulated at 4 per cent – in the annual budget.
- All of the fund's capital is to be invested in international markets.

After nearly three decades of spending the petroleum revenues more or less as they came in, the fiscal rule enabled the government to save for future generations. At the same time, the rule made fiscal policy more robust: By decoupling spending from current petroleum revenues, the fiscal rule provides for a gradual and sustainable phasing-in of petroleum revenue spending. The guidelines ensure the necessary flexibility to allow automatic stabilisers to work, and they allow for careful countercyclical policy. The savings plan has remained intact and the Fund has now reached a size of nearly NOK 4 trillion, or 130 percent of GDP.

When the fiscal rule was introduced in 2001, Norges Bank was charged with the task of keeping inflation low and stable. Thus, our traditional fixed exchange rate policy was abandoned. A clear division of responsibilities between monetary and fiscal policy was now established.

Norges Bank's conduct of monetary policy is geared towards low and stable inflation. The operational target of monetary policy is consumer price inflation of close to 2.5 per cent over time. When setting the key policy rate, we also take into account the impact of the interest rate on output and employment. In addition we give weight to the risk that a prolonged period of low interest rates can lead to elevated risk-taking and excessive debt accumulation in the household and business sectors. Inflation targeting has become more flexible.

The present economic situation in much of the rest of Europe stands in contrast to ours. In Norway, domestic activity is high, and particularly so in the oil industry and the construction sector. Unemployment remains low and stable. But the Norwegian economy is not unaffected by the turbulence abroad. Weak demand from Europe and a strong krone exchange rate are holding back some segments of the Norwegian export industry.

Even though capacity utilisation is above a normal level, the key policy rate in Norway is low because inflation is low and interest rates abroad are very low. These factors are limiting how quickly the key policy rate in Norway can be raised.

Despite some disturbances to the economy over the past decade, inflation in Norway has been low and stable, showing that monetary policy has functioned effectively. With firmly anchored inflation expectations, Norges Bank has also been able to consider economic stability when setting the key policy rate. We are constantly learning more about the interaction between monetary policy and financial stability, and as mentioned inflation targeting in Norway has become more flexible. At the same time, we cannot overburden monetary policy. In balancing the various considerations, we will adhere to the primary objective of monetary policy – low and stable inflation.

It is too early to say whether Norway has really managed to contain the Dutch disease. Our framework has still not been tested against a large and persistent negative oil price shock. From a high starting point, wages have grown faster in Norway than among our trading partners for the past ten years. Our currency has appreciated considerably in real terms. I believe the real test of our framework will come when the present boom in the petroleum industry – at some point – is reversed.

Thank you for your attention.