The economic situation in Norway

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Norway's economy is today characterised by substantial petroleum revenues, sharp growth in government expenditure, a tight labour market and high cost inflation.

High oil prices and sizeable petroleum production are contributing to surpluses on the current account and the central government budget. This has also resulted in a vigorous rise in Norway's disposable income. The current account surplus in 2000, which was about 14 per cent of GDP, is among the highest surpluses recorded by an OECD country in the post-war period. The total general government budget surplus also rose sharply, reaching 141/2 per cent of GDP.

With the exception of a brief pause in growth from the summer of 1998, the Norwegian economy has been expanding since 1993. Employment has risen and unemployment has fallen to just over 3 per cent. A shortage of labour in many sectors has resulted in a relatively sharp growth in labour costs.

Whereas the upturn was balanced for a long period, the public sector has laid claim to a large share of the increase in the labour supply in recent years. Manufacturing employment has fallen markedly since 1998.

Working time reforms, increased use of sick pay and disability benefits and a reduced supply of labour from other Nordic countries are restraining growth in many sectors. Moreover, there is no evidence suggesting that productivity growth in Norway has picked up to the levels in some of our neighbouring countries.

The economic situation

The mainland economy features some aspects that are associated with a boom period, although growth is low. After several years of mainland GDP growth in the order of 3-4 per cent, activity is now increasing by less than 2 per cent a year. Economic growth slowed towards the end of last year, but there is still a shortage of labour. The economy is operating near capacity limits, and wage and price inflation is higher than among our trading partners.

Consumer prices increased by an average of 3.1 per cent last year. Excluding changes in electricity and fuel prices and indirect taxes, the underlying rise in prices was 2.4 per cent.

Last year Norges Bank increased its key interest rates four times by a total of 1.5 percentage points. At the end of the year the sight deposit rate stood at 7 per cent. The interest rate differential vis-à-vis the euro-area widened somewhat to 23/4 percentage points through the year.

Last week Norges Banks published its most recent analysis of the outlook for the Norwegian economy in our Inflation Report. Norges Bank projects consumer price inflation at 3 per cent in 2001. If interest rates remain unchanged at the current level, price inflation may approach 2 per cent from the end of 2002.

Consumer price inflation is influenced by the increase in oil prices. The sharp rise in 1999 and 2000 is expected to continue to have an impact on prices for goods and services, particularly this year.

Our analysis indicates that the slowdown in activity that started in the last half of the previous year will continue this year. From next year, however, we expect activity to pick up somewhat. Increased optimism in some manufacturing sectors and higher petroleum investment would indicate more positive developments in manufacturing. On the other hand, international developments have been somewhat weaker than expected.

The uncertainty surrounding international developments is primarily associated with the severity of the downturn in the US and how long it takes before growth picks up again. A pronounced downturn that has an impact on the world economy will reduce consumer price inflation internationally. The effects of such a turnaround on the Norwegian economy will, however, be mixed. Substantial parts of the Norwegian export industry are already producing near capacity, and the slowdown is expected to have little impact on this sector. The effects on developments in commodity prices and exchange rates are uncertain. If the international slowdown develops into a situation where commodity prices are severely negatively affected, the Norwegian economy may suffer. I will elaborate on the risks and uncertainties in the international situation later.

Mainland GDP is projected to grow by 11/4 per cent in 2001. With unchanged interest rates in the period ahead, annual mainland GDP growth may be 11/2 per cent the next two years. The relatively high interest rates - the three-month money market rate is currently at around 71/4 per cent - will contribute to modest growth in private consumption and fixed investment. Public expenditure is expected to grow in line with potential output at around 2 per cent.

Pressures in the labour market remain strong. We expect the unemployment rate to remain at just over 3 per cent in the years ahead. Underlying this projection is an employment growth of roughly 1/2 per cent, equal to the growth in the labour force.

The increase in labour costs has been higher in Norway than among our trading partners in most of the last decade. This situation will continue, even if wage growth is expected to fall somewhat in the years ahead. High growth in labour costs is the main reason consumer price inflation increased through last year.

The international environment

In the last few years, international developments have led to major changes in the outlook for the Norwegian economy. In 1998, the crisis in Russia triggered a strong depreciation of the krone, rising interest rates and weakening domestic demand. At the same time weak developments in Asia contributed to falling oil prices and a slower rise in prices for imported goods. The international recovery was fast, and through 1999 and 2000 world trade expanded. The price of crude oil increased from USD 10 per barrel at the beginning of 1999 to USD 29 per barrel on average last year. Rising oil prices contributed to higher consumer price inflation.

International equity prices declined sharply last autumn. The downward trend continued in the first months of this year. In the US, output and employment are stagnating. As shown in the chart, the risk premium in capital markets on long-term credit to enterprises has increased. In addition, many international enterprises now have a poorer credit rating than earlier.

At present it is not clear how severe the downturn in the US economy will be. The continuing upturn during the 1990s was driven by high growth in productivity, increased fixed investment and a steady decrease in household saving. If the downturn entails a complete reversal of this development, the economic slowdown will be more severe than we have anticipated. The effect on the Norwegian economy will to a large extent depend on the reactions in commodity, financial and capital markets.

Lower international economic growth and inflation could induce a further lowering of short-term interest rates abroad in the next months. The interest rate differential between Norwegian rates and international rates may then widen.

The price of crude oil plays a major part in international economic cycles. If the oil price falls significantly, inflation will decrease due to reduced imported inflation and lower energy prices. On the other hand a falling oil price may trigger a weakening of the krone, offsetting the effects of reduced import and energy prices.

The pricing of options in the oil market indicates that market participants are uncertain with regard to future developments. This uncertainty must be viewed against the backdrop of low oil stocks, high capacity utilisation in a number of OPEC countries and unrest in the Middle East, which may have contributed to fears of high prices. OPEC has previously stated that the oil price should lie within a target range of USD 22-28 measured as an average of various grades of oil. For North Sea oil (Brent Blend), this corresponds to an interval of USD 23-29. The vertical lines in the chart indicate that at the end of February market participants priced in a 10 per cent probability that the oil price in December 2001 would be less than USD 18 per barrel, and a 10 per cent probability that it would be higher than USD 35.5 per barrel.

Should a significant fall in the oil price occur, this would dampen activity in the Norwegian economy, in contrast to an expected boost in oil importing countries. Reduced income in the petroleum sector will reduce fixed investment, and consumer confidence may be negatively affected.

Monetary policy

The long-term objective of monetary policy is to provide the Norwegian economy with a nominal anchor - domestic price stability - and thereby the basis for a stable krone. Nominal stability is the best contribution monetary policy can make to economic growth and prosperity. A nominal anchor is also a necessary precondition for stable financial markets and property markets.

By linking movements in the krone to the euro, we have chosen to follow the same standard for nominal stability in the economy as set by the euro area countries.

Our experience is that changes in the Norwegian interest rate level only have a predictable effect on the krone exchange rate when the change in interest rates also contributes to stabilising inflation. However, the relationship between interest rates and price and cost developments is uncertain. The setting of interest rates thus requires the use of professional judgement and discretion. The basis for exercising discretion is subject to limitations, however. Should any doubt arise as to whether the interest rate is oriented towards nominal stability, this would trigger substantial capital movements.

Since 1997, inflation has been higher in Norway than in the euro area. The difference partly reflects a period of strong growth in Norway, while the level of activity in Europe has been low. The higher level of inflation in Norway cannot be sustained, however, as this would undermine the basis for stability in the krone exchange rate and confidence in monetary policy. As I mentioned earlier, in our projection price inflation approaches 2 per cent from the end of 2002 if interest rates remain unchanged at the current level.

Short-term capital inflows and outflows are probably the most important factor determining movements in the krone exchange rate from day to day, from week to week and from one quarter to the next. They are governed by expectations concerning future returns. Changes in expectations concerning the future value of the krone can trigger extensive capital movements.

As a rule, Norges Bank does not intervene in foreign exchange markets with a view to influencing the krone exchange rate. The krone is floating, and the value of the krone fluctuates in periods by the same magnitude as exchange rates in other open economies. Nevertheless, the prevailing stability of the krone is largely a reflection of confidence that inflation in Norway will be kept at a low level.

Interaction with income formation

A precondition for a stable krone exchange rate against European currencies is that price and cost inflation in Norway must over time not exceed the corresponding aim for inflation of the European Central Bank (ECB). The ECB orients monetary policy instruments towards price stability, and has defined price stability as an inflation rate below 2 per cent. The rise in prices for imported goods is expected to continue to be relatively low, leaving room for a somewhat higher rise in prices for domestically produced goods and services. Over time, productivity growth determines the level of wage growth that is consistent with stability in prices and the exchange rate. With productivity growth around the average for the 1980s and 1990s, i.e. in the order of 11/2 per cent per year, nominal wage growth should be brought down to between 3 and 4 per cent. There will be room for higher wage growth if productivity growth increases.

In recent years, cost inflation in the euro area countries and among trading partners has been relatively low. Growth in labour costs in Norway has been roughly 11 percentage points higher than in the euro area in the past three years.

A number of other small open economies have recorded a decline in unemployment and lower growth in labour costs than Norway. In Sweden, unemployment has shown a substantial decrease over the past five years and wage growth is below 4 per cent. Three-year wage agreements are now being concluded, underpinning the basis for low cost inflation. In the Netherlands, unemployment has fallen to a very low level. Wage growth has picked up, but is lower than in Norway. In Denmark, unemployment has come down without an increase in wage growth. In Finland, unemployment has fallen sharply from the high level that took hold in the 1990s, and wage growth has slowed. In the euro area, unemployment has dropped without an increase in wage growth. In Norway, the high growth in labour costs may be a source of rising unemployment.

Norwegian key rates are currently 11/2 percentage points higher than in the US, 21/4 percentage points higher than in the euro area, and 3 percentage points higher than in Sweden. In some countries, short-term interest rates are now moving down and in other countries expectations of interest rate increases have receded. Norges Bank has a neutral bias with regard to interest rates developments, partly reflecting price and cost developments in Norway, as illustrated in the chart.

Interaction with fiscal policy

It is important that the annual budgets are based on a long-term strategy that takes into account possible fluctuations in oil revenues from one year to the next. With large and, to some extent, varying budget revenues, the basis for determining central government expenditure and taxes from one year to the next may easily be impaired. If budget spending is allowed to vary in step with oil prices, the Norwegian economy may experience abrupt shifts and instability. Changes in oil prices may then quickly influence wage and price expectations, the exchange rate and long-term rates. In addition, short-term rates would have to be changed frequently and sharply.

In recent years, central government real underlying spending growth has accelerated somewhat. Both in 2000 and 2001, spending growth has been higher than 2 per cent, which is above potential growth in the mainland economy. At the same time, taxes have increased. Fiscal policy has thus had a virtually neutral effect on domestic demand for two years while wage growth has been substantially higher than in other countries.

A possible interpretation of this development is that it is more demanding to use the government budget to dampen cyclical fluctuations during an upturn than during a downturn. The willingness and ability to pursue a counter-cyclical policy may in itself be cyclical.

Another interpretation is that a neutral fiscal policy in a year featuring a sharp increase in government financial assets reflects a balance between using the government budget to stabilise the economy and phasing in higher financial revenues in the economy.

Irrespective, a gradual shift in economic policy is taking place. While fiscal policy is having a neutral impact on domestic demand, monetary policy is having a contractionary effect. This is partly reflected in higher short-term rates compared with long-term rates. The focus of the income settlements may also be said to have changed somewhat since the mid-1990s, with less emphasis on balanced labour market developments.

Natural resources and growth capacity

Petroleum revenues fluctuate widely, with substantial uncertainty as to future developments. This raises the question of how quickly petroleum revenues shall be used. The term "Dutch disease" was first used to describe the situation in the Dutch economy in the 1970s and 1980s after revenues from the large gas finds in the Groningen field were used to finance strong growth in public expenditure. When the gas revenues declined and growth in the economy came to a halt, a tightening of policy was necessary and unemployment rose.

An abundance of natural resources should be considered a gift of nature and an advantage for any country. At the same time, the experience of other countries indicates that in the long run the supply of natural resources can prove to be just as much of a disadvantage as an advantage for a nation's economy. Many countries with an abundance of natural resources are poor today. They have not used the resources to provide for sustainable higher income. It would appear that easy money could reduce the growth capacity in an economy.

I will address four main challenges in turning petroleum wealth into a sustainable benefit for the current and future generations of Norwegians:

First, in countries with substantial revenues from natural resources, growth conditions for the internationally exposed sector may become less favourable. The exposure of large parts of the economy to intense foreign competition provides a breeding ground for learning, innovation and development. Competitive pressures in sheltered sectors, such as internal trade and public enterprises, are normally more limited. In my view, it is essential to maintain a broad exposed sector in the mainland economy, primarily because of the effect this has on the growth capacity of the economy.

Second, substantial petroleum wealth can weaken financial discipline in enterprises that are financed or assume that they can be financed by the public sector. The moral hazard problems associated with our "from cradle to grave" welfare systems may also be compounded.

If enterprises assume that the central government will provide support, resources may be squandered and the risk of substantial losses may be given little emphasis. The organisation of public enterprises is thus important. The central government's financial responsibility for individual enterprises and for other levels of public administration must be delimited in a credible manner.

Third, petroleum production generates a profit in excess of a normal return, i.e. economic rent. As economic rent accrues to the state, the central government is accumulating substantial capital in the Government Petroleum Fund. A strong interest in gaining access to this capital can easily arise. There is a risk that entrepreneurship, talent and energy in the business sector and political life are used to acquire a piece of the economic rent rather than for innovation, restructuring and growth. Decision-making forms in economic and political life must provide an effective shield to prevent special interests from gaining a dominant influence and control over petroleum wealth. The EEA Agreement restricts the scope for favouring individual enterprises or groups of enterprises. It is important for growth capacity in the Norwegian economy that both national and international competition authorities engage in effective supervision in order to avoid the development of a business sector that is dependent on protection.

Last, but not least, we must aim to ensure a high rate of return on petroleum wealth and financial assets in public ownership, within acceptable risk limits. This pertains to both the Government Petroleum Fund, the state's direct financial interest in petroleum activities and other public assets such as the state's direct ownership interests in enterprises and assets in the National Insurance Fund.

Conclusions

Let me conclude by summing up as follows.

Continued high oil prices have reduced income growth in many countries and are contributing to the turnaround in the US. The effect of high prices for oil and other commodities is different for the Norwegian economy, with large profits in some export industries and substantial surpluses on government budgets and the current account. The high level of oil prices is boosting petroleum investment and holding up household income expectations.

The Norwegian mainland economy is operating near capacity limits, although growth is low. Wage growth and inflation are higher than among our trading partners and in the euro area. As a result, we have a higher level of short-term interest rates than in most other European countries.

Thank you for your attention.