Svein Gjedrem: Norwegian experiences in balancing economic development with macroeconomic stability - a historical perspective

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the Norwegian Embassy, New Dehli, 21 March 2006.

The Charts in pdf-format can be found on the Norges Bank's website.

The speech does not contain assessments of the economic situation or the monetary stance. Please note that the text below may differ slightly from the actual presentation.

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Excellencies, Ladies and Gentlemen,

It is a great honour to address you today on behalf of Norges Bank. The ties between Norway and India seem to be growing stronger, in spite of the geographical distance and vast differences between our two countries. Over the last few years, a number of Norwegian companies have entered the Indian market or strengthened their involvement in India. For example, the Norwegian oil and gas company Norsk Hydro reports that almost 300 000 hours of engineering services for the natural gas field Ormen Lange were supplied by Indian engineers, located in India. Last year, the Government Pension Fund made its first investments in the Indian stock market. By the end of 2005, the Fund had holdings in more than 70 Indian companies. There are also numerous cultural ties. This year, Norway is commemorating our most famous playwright Henrik Ibsen. A wide range of events is being arranged both in Norway and abroad. Of particular interest is that Indian actors are providing fresh interpretations of Ibsen's work, both in India and in Norway.

The topic of my speech today is Norwegian experiences in balancing economic development with macroeconomic stability from a historical perspective. As a background for the subject, let me start with a brief characteristic of Norway today from an economic perspective.

First, Norway is a small, mountainous country with a population of only 4½ million people scattered across a land area that is one tenth of the size of India. Second, Norway's economic growth has been favourable for many years, and the per capita income is among the highest in the world. An abundance of natural resources, not least oil and gas, and openness to trade and capital movements are important reasons for this. The petroleum sector's share of GDP was approximately 24 per cent in 2005. Over the last 10 years, the government has earned higher petroleum revenues than it has spent. Today we have a sizeable Government Pension Fund, which invests all its funds globally.

Globalisation and cyclical developments have been kind to the Norwegian economy. Prices for our imported goods are falling in relation to prices for goods we export. Norway's terms of trade are improving. The impact of the rise in oil and gas prices is particularly strong, but the terms-of-trade gains for the mainland economy have also been high. One aspect of this is that trade in services with India is increasing.

Petroleum and luck is, however, not the whole story behind the high per capita income in Norway. We have also been successful in seizing the opportunities that have been offered by changing international environments. The foundations for the Norwegian welfare state were established some two hundred years back in history.

Long-term economic developments

The Napoleonic Wars, which tormented Europe in the early 19th century, brought some great changes to the face of Europe. Norway took this opportunity to adopt a constitution and establish a number of central governmental institutions, including a central bank.

Norway was severely hit by the economic crisis that followed the war, and around 1820 Norway's GDP per capita was lower than in many comparable countries. In the second half of the 1820s, a new period of economic expansion started. The upturn gathered momentum from the middle of the century. An event which had a considerable impact on Norwegian shipping and economic history took place in 1849 when England repealed all navigation acts regulating the right to transport goods to and from England and its colonies.

This new and more competition-friendly trade environment spurred a rapid build-up of the Norwegian commercial fleet. Norway suddenly became a major exporter of services. As the chart shows, the tonnage of the Norwegian commercial fleet increased almost six-fold from 1850 to 1880. By 1880, Norway had built up the world's third largest commercial fleet.

In the latter part of the 1800s, Norway benefited greatly from free trade and free capital movements and became a relatively prosperous country. Access to international technology, competence and capital were important when the first industrial base was established in the late 19th century. The banking sector also expanded rapidly in this period.

As this chart shows, value added in manufacturing and services became more important and increased as a share of total GDP. Employment and value added in agriculture, fisheries etc., on the other hand, declined markedly. By the beginning of the 20th century, the standard of living in Norway did not lag behind that of other European countries. This change in industry structure is necessary and lies at the heart of economic development.

The second half of the 19th century also represents a golden age for Norwegian cultural development, with the literature of Henrik Ibsen, the music of Edvard Grieg and later the paintings of Edvard Munch.

In the period preceding the First World War, the world experienced a period of strong growth in trade and cross-border capital flows. There were few political barriers and major technological advances fostered growth in trade. Prosperity increased. But this period was interrupted, and in the interwar period protectionism gained ground, with trade barriers and a contraction in international trade. This was combined with deep economic recessions.

Economic policy after the Second World War

After the Second World War, a strong belief evolved in Norway that the economy could be controlled and steered in the desired direction. The support for a market economy lost ground after the recessions and financial instability in the interwar period. Economic policy was marked by coordination, control and regulation. At the same time, Norway took part in international organisations. International organisations made an effort to promote economic cooperation and increased integration of international trade and fixed investment. Trade barriers were gradually scaled back and trade picked up already in the 1950s. Capital movements remained strongly regulated, however.

Maintenance of a high level of fixed capital formation in inter alia infrastructure and private and public industrial companies was an important part of economic policy after the war. The fixed investment-to-GDP ratio stayed at a historically high level until the late 1970s. On the other hand, low or negative real interest rates, combined with credit regulation, contributed to a low return to capital and an inefficient use of resources. Since the late 1970s, the investment ratio has declined in Norway as in many other European countries. India, on the other hand, is in the process of catching up. High investment growth in infrastructure as well as in businesses is probably important to maintain high economic growth in India.

The government sector in Norway increased in importance until the beginning of the 1990s. Taxes were raised to support increased use of resources in the public service sector and to support a rising level of transfers between households and industries.

The regulatory economic policy in the post-war period was, however, not sustainable. This policy was at the root of many of the problems that followed in the 1970s and 1980s. Today's formulation of economic policy reflects the experience gained and the lessons learned in these two decades.

The economic policy contributed to wide fluctuations in the Norwegian economy. Inflation became high and variable. This was largely due to a perception in the 1960s and 1970s that strong growth and low unemployment could be achieved if we were only willing to accept somewhat higher inflation. But it was gradually recognised that there was no such trade-off.

The absence of a nominal anchor was one of the main reasons behind the pronounced swings in the Norwegian economy. With a policy of low interest rates and devaluations, inflation took root. Nominal interest rates were kept at a low level even though inflation rose. Frequent devaluations from 1976 were unable in the long term to prevent a decline in the manufacturing sector. On the contrary, they proved to be self-reinforcing. The wide fluctuations culminated in a credit boom in the mid-1980s.

The fluctuations were reinforced by oil price shocks and the use of expected revenues from oil production. The government began already in the 1970s to budget on the basis of future strong growth in petroleum revenues. The result was that we spent a large share of our petroleum wealth in the 1970s and 1980s. Welfare schemes were expanded significantly. Manufacturing industry was scaled back. The recession after the credit bubble burst and oil prices fell in 1986 was deep. The recession was deeper than would have been the case if we had maintained a larger and competitive manufacturing sector. Norwegian industry lost export market shares in the late 1980s in spite of the booming conditions abroad and substantial capacity slack at home.

It was recognised that a substantial revision of economic policy would be necessary and that the problems created by inflation had to be taken seriously. The exchange rate was chosen as the nominal anchor in 1986. A fixed exchange rate was an intermediate target for achieving low and stable inflation. Inflation fell gradually to 2-3 per cent in 1991-1992.

We had to abandon the fixed exchange rate policy in 1992. An important reason was the weakness inherent in the fixed exchange rate regime in a world with free capital flows and deep financial markets. The krone exchange rate showed, however, little change to begin with and rapidly found a new range.

A formal inflation target for monetary policy was introduced in the spring of 2001. The operational target of monetary policy as defined by the government is inflation of close to 2.5 per cent over time. Many countries had already gained many years' experience in operating such a system. New Zealand was the first in line towards the end of the 1980s. Canada followed shortly thereafter.

Developments over the past 40 years illustrate that the most important contribution monetary policy can make to sound economic developments in the long term is low and stable inflation. This provides the economy with a nominal anchor.

Low and stable inflation makes it easier for economic agents to distinguish changes in relative prices from changes in the general price level. Prices become a more accurate information vehicle. Through the 1990s, inflation generally remained in the interval 1½ – 3½ per cent.

When there is confidence in the inflation target, monetary policy can also contribute to stabilising output and employment.

Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment in interest-rate setting. In order to make forecasts for inflation and output, we must also judge how interest rates will develop in the future. If inflation deviates substantially from the target for a period, the interest rate will be set with a view to returning it gradually to the target, so that we avoid substantial variations in output and employment. This chart illustrates the judgement as published in the latest *Inflation Report*.

Past experience indicates that expectations as to future inflation remain stable even if inflation varies somewhat as long as the interest rate is used actively to curb the effects. Monetary policy cannot fine-tune economic developments, but it can prevent the largest effects from occurring when the economy is exposed to disturbances. In some situations, it may be appropriate to take into account particularly unfavourable developments.

In a period of increased cross-border labour flows, substantial technological advances, changes in competitive conditions and new trading patterns, Norway may, with our very open economy, have to accept somewhat greater variation in inflation and deviations from the target, as we have witnessed over the past two to three years.

Challenges in an oil economy

Petroleum revenues pose as mentioned special challenges to stabilisation policy. The experience of other countries that had received large, unexpected income from natural resources was not encouraging. The classic example is Spain's substantial revenues from the colonisation of America in the 1600s. The historian David Landes[1] summarised the Spanish experience as follows:

Landes stated that easy money is bad for a country. It is very tempting to live comfortably on this income and be less concerned about safeguarding other revenue sources. In that case, the country is poorly poised to cope with an end to easy money.

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[1] David Landes (1998): The Wealth and Poverty of Nations, W.W. Norton & Company, Inc., N.Y.

The oil age in Norway has spanned 30 years and it appears that it will continue for many years ahead. Petroleum activities give Norway an economic base that is not available to many other countries. But it also presents us with many challenges.

First, petroleum wealth is part of Norway's national wealth. It is misleading to look upon the cash flow from petroleum activities as income. The appropriate economic perspective is to see the transfer of the cash flow to the Government Pension Fund as a way of transferring capital from one account to another – from petroleum to foreign securities. By doing so, we diversify risk. We must also strive for an equitable distribution of this wealth across generations.

The Norwegian authorities have been successful in ensuring that the bulk of petroleum wealth benefits society as a whole. Both the state's ownership interests through the State's Direct Financial Interest in petroleum activities (SDFI) and the tax system have contributed. The companies that extract oil earn a reasonable return on their investments and have incentives to invest, but the economic rent has essentially accrued to the general public.

Second, the size of the cash flow from petroleum activities also varies. If petroleum revenues were to be used as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy.

Third, the use of petroleum revenues has an impact on competitiveness in Norwegian business and industry. A high level and substantial variations in the use of petroleum revenues would have a negative impact on internationally exposed industries.

The establishment of the Government Pension Fund and the spending guidelines for petroleum revenues are intended to meet these challenges.

The government earns large net cash flows deriving from the oil companies' sale of petroleum products in foreign markets. The Pension Fund serves as a buffer between current petroleum revenues and spending these revenues in the Norwegian economy. All central government revenues from petroleum operations shall be transferred to the Fund.

According to the fiscal rule that has been approved by the Norwegian parliament, petroleum revenue spending shall be limited to 4 per cent or the expected annual real return on the Pension Fund over time. This partly insulates the economy from fluctuations in oil prices and extraction rates in the petroleum sector – and when followed it ensures that revenue spending in the Norwegian economy is at a level that can be sustained over time. The difference between the net cash flow and spending is reinvested in foreign financial markets.

The Petroleum Fund also functions as a buffer and dampens the wide fluctuations in the krone exchange rate that petroleum revenues might otherwise have generated. Operators in the foreign exchange market may at times have a tendency to underestimate the Fund's function as a stabilisation mechanism. The capital outflows through the Fund contribute to both curbing the appreciation of the krone and maintaining its stability.

At the end of 2005, the market value of the Pension Fund's portfolio was roughly 73 per cent of GDP. As shown in the chart, the value of the Fund is rising rapidly and may continue to do so in the years ahead. The Fund is now approaching the nominal value of one year's GDP and may reach two in the course of the next decade.

On the other hand, Norway, like many other countries, is facing substantial fiscal challenges. Financing the large pension payments that will have to be disbursed in the coming years will be very demanding.

Final remarks

To sum up, Norway has a market economy and a large government sector. The way in which economic policy is oriented today reflects the knowledge gained and the lessons learned.

We know from experience that fiscal policy alone cannot ensure a high level of employment. The structure of the labour market and wage formation are probably of greater importance. The direct regulation of credit, interest rates and capital movements collapsed and was phased out in the 1980s. Price regulation no longer plays a role as a macroeconomic instrument. The scope of business policy has become more general.

The most important contribution monetary policy can make to sound economic developments in the long term is low and stable inflation. Low and stable inflation has contributed to solid growth in the global economy in recent years.

Thank you for your attention.