Øystein Olsen: Oil and the Norwegian economy – the challenges ahead

Speech by Mr Øystein Olsen, Governor of the Norges Bank (Central Bank of Norway), at a lunch hosted by Danske Bank Markets, New York City, 27 March 2015.

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Accompanying slides can be found on the Norges Bank's website: Slides (PDF).

It's a great pleasure to be in New York City again and an honour to be invited to give a lunch presentation here today.

As Norges Bank, a week ago, published its latest monetary policy report, the economic outlook and the considerations behind the interest rate decision naturally warrant some attention in my speech today. First, however, I would like to give some background information on the economic policy framework in Norway, focusing on the sovereign wealth fund – the Government Pension Fund Global – the fiscal rule and Norges Bank's foreign exchange transfers to the fund.

Norway is a small, open, natural resource-rich economy. About a quarter of our GDP is related to oil and gas extraction, and a large share of our petroleum production is exported.

The oil and gas industry has played a vital role for the strong growth in our economy over the past 40 years. When the first oil was brought to the surface in 1971, GDP per capita in Norway was lower than the average for a western economy. The picture has reversed since then. We have gradually caught up to the wealthiest nations. Measured by GDP per capita, Norway now ranks close to the top.

Even if we disregard the oil sector's contribution to growth for a moment, Norway's mainland economy has shown relatively robust developments. The ripple effects from activities on the continental shelf to the wider economy have been wide-ranging. A growing number of firms have targeted the oil industry. A state-of-the-art oil service industry has emerged. For many firms, the contracts on the Norwegian continental shelf have been a springboard to new export markets.

Although Norway's oil age began 40 years ago, the past 15 years stand out. From the end of the 1990s to 2013, the price of North Sea oil rose from about USD 10 to over USD 100 per barrel. High oil prices and a profitable petroleum production industry have been accompanied by record-high oil investment in recent years. Increased spending of petroleum revenues over the fiscal budget has provided a growth impetus to domestic demand. Employment has remained high and unemployment low for many years, even when the financial crisis hit in 2008.

It was made clear at an early stage that Norway's oil and gas resources belong to the Norwegian people and should be managed on their behalf. The tax system for private and state-owned oil companies and framework conditions for the petroleum industry were designed so that the bulk of the large resource rents generated by the industry would accrue to the Norwegian state.

We have avoided making public sector budgets dependent on volatile income. This has mainly been achieved by establishing the sovereign wealth fund and a fiscal rule imposing a constraint on oil revenue spending.

The Norwegian parliament passed the Act relating to the fund in 1990. Under the Act, the net budget surplus, including oil revenues, is transferred to the fund, and invested in international markets.

The policy guidelines were clarified in 2001 through the introduction of the fiscal rule. Under these guidelines, government spending of oil revenues – measured by the non-oil budget deficit – is limited to the expected real return on the fund – estimated at 4 percent annually. The idea is to leave the capital in the fund untouched, saving it for future generations.

The fiscal rule provided for a gradual phasing in of oil revenues. Over time, we would have to expect the real krone exchange rate to appreciate as a result. However, due to the fund mechanism and the fiscal rule, actual spending is decoupled from current petroleum revenues.

This has curbed the appreciation of the krone and thus reduced fluctuations in the exchange rate. Compared to other resource-based economies, the real krone exchange rate has remained relatively stable, especially during the period of substantial increases in oil prices (cf. diagram).

Let me elaborate on the transactions that actually take place. All revenues from the sale of oil and gas are originally in foreign currency. The oil companies convert some of their foreign exchange revenues to kroner in order to pay taxes and dividends to the government. In addition to tax and dividend revenues in kroner, the government has large revenues in foreign currency from its ownership shares in petroleum fields on the Norwegian continental shelf.[1]

As long as government revenues in kroner from the petroleum sector exceed annual petroleum revenue spending over the budget, the government is left with a surplus of kroner. This was the situation up until 2014.

Norges Bank converted this surplus into foreign currency, which was in turn transferred to the fund. The amount of kroner converted into foreign exchange partly offset the amount of kroner previously bought by the oil companies. Consequently, these operations should not have any impact on the real exchange rate.

In 2015, government spending of petroleum revenues over the budget is estimated to be higher than the revenues received in kroner. Government petroleum revenue spending over the budget has increased over time, in pace with the increasing size of the fund. And recently, the government's net cash flow from the petroleum sector started to decline. As a consequence, Norges Bank will move from a position of selling surplus kroner to selling foreign currency in order to finance petroleum revenue spending. However, the effect on the real exchange rate will still be determined by the amount of petroleum revenues spent over the fiscal budget.

It is not Norges Bank's intention to influence the krone exchange rate through these foreign exchange transactions. Accordingly, purchases are distributed evenly through the year. At the end of each month, Norges Bank announces the size of the daily purchases or sales of kroner for the coming month, based on estimates of oil revenues and fiscal spending. The amount can be interpreted as our best estimate for the remaining months of the year.

The economic outlook

Let me now turn to the outlook for the Norwegian economy. We are about to leave behind us 15 golden years. The Norwegian economy has made use of favourable tailwinds and seized the opportunities offered. The other side of the coin is an economy that has become increasingly dependent on oil, and thereby more vulnerable to changes in oil prices and petroleum revenues. And as we know, oil prices have fallen by nearly 50 percent since last summer.

The vulnerability manifests itself in several ways. A large share of the business sector and the labour market is linked to the petroleum sector in Norway and in other countries.

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[1] Revenues received from the State's Direct Financial Interest in the petroleum sector (SDFI).

Petroleum investment, which has long been an important driver of growth in the Norwegian economy, is now expected to fall in the years ahead. The fall in oil prices in recent months has accelerated and amplified an announced decline in the activity level on the Norwegian continental shelf. Lower oil prices reduce oil company cash flows and reduce the profitability of new investments. Field development projects that are now underway will be affected, although to a limited extent. In addition, some new projects may be postponed or cancelled.

Lower demand for goods and services from the petroleum sector has spillover effects on the mainland economy, with a dampening effect on labour demand.

The fact that activity in the petroleum sector is declining does not mean that the oil age is coming to an end. Nearly half of known oil and gas reserves on the Norwegian continental shelf have not yet been extracted. And large new discoveries have been made over the past few years. Nonetheless, the Norwegian economy must adapt to considerably lower demand from the oil sector. We will be more dependent on growth in other sectors to support growth in the economy.

Another challenge is Norway's high labour costs. The cost level in the business sector has increased sharply relative to our trading partners. To underpin a necessary transition towards non-oil industries, the cost level in Norway must again be brought more closely into line with that of our trading partners.

A necessary adjustment of the cost level in Norway can occur by means of lower wage growth in Norway than in other countries or a depreciation of the krone exchange rate.

In Norway, monetary policy is geared towards keeping inflation low and stable. The operational target of monetary policy is consumer price inflation of close to 2.5 percent over time. The inflation target provides the economy with a nominal anchor. When inflation expectations are firmly anchored, monetary policy serves as the first line of defence when the economy turns down.

Over time, monetary policy can only influence inflation. Monetary policy cannot take primary responsibility for delivering the necessary structural changes in the Norwegian economy. But monetary policy can help facilitate the necessary restructuring process via the exchange rate channel. As long as there is confidence that inflation will remain low and stable over time, a pronounced depreciation of the krone can go hand in hand with a low key policy rate.

The krone has depreciated markedly since last September and is now about 10 percent weaker than the average for the first half of 2014. Developments in the krone exchange rate must be seen in the context of lower oil prices and weaker growth prospects for the Norwegian economy.

The depreciation of the krone underpins inflation and softens the impact of lower oil prices on the Norwegian economy. As seen in the diagram a weaker krone boosts competitiveness for Norwegian firms facing competition from abroad. At the same time, wage growth has moderated to some extent. There are prospects that real wage growth this year will be at its lowest for nearly 20 years.

With improved competitiveness, export firms are in a better position to maintain market shares. As growth picks up abroad, demand for Norwegian goods and services may also increase. At the same time, petroleum-related exports, which account for about a quarter of mainland exports, will likely decrease due to a decline in global offshore investment.

It will likely take time for the effects of lower oil prices on the mainland economy to become fully visible. So far, unemployment has only shown a slight increase. A flexible labour market appears to be curbing the rise in unemployment.

Employment growth has also remained firm, although an increasing mismatch between the number of unemployed and job vacancies points towards more slack in the labour market. In regions and sectors closely linked to the petroleum sector, unemployment has increased.

Weaker growth prospects may reduce the willingness of mainland firms to invest. On the other hand, improved competitiveness will provide a basis for expanding capacity in some sectors. In addition, housing investment is likely to support overall investment activity. House price inflation remains high.

Growth in household consumption has been moderate in recent years and household saving has reached a high level, in spite of low interest rates. The pension reform and uncertainty surrounding economic developments have probably induced households to increase saving. Overall, we expect growth in private consumption to remain moderate ahead and the saving ratio to remain at a high level.

Debt-to-income ratios for Norwegian households are high, reflecting a long period of rapidly rising house prices. Low interest rates on loans to households are expected to fuel house price inflation, while prospects for weaker income growth and somewhat higher unemployment may have a dampening impact further ahead.

For some time, based on experience from the recent financial crisis, financial stability considerations have to some extent influenced monetary policy. Put in other words: we have been “leaning against the wind”.

As a small open economy, Norway is highly influenced by economic developments abroad. Many advanced economies have experienced a difficult time since the global economy was severely hit by the financial crisis. Global growth is expected to pick up. The fall in oil prices is a positive factor for the world economy. But the picture is mixed. In the US, the recovery seems to be on a firm footing. Developments in the UK and Sweden, two of Norway’s major export markets, have also been positive, although inflation remains a challenge. The situation in the euro area appears to be more problematic. A large portion of the workforce is unemployed and production equipment stands idle. Inflation is worryingly low.

Through winter, a number of central banks have undertaken unconventional monetary policy easing, and market expectations with regard to key rates in trading partner countries have fallen further. Low interest rates abroad influence the krone and thereby the prospects for inflation, contributing to low interest rates also in Norway.

In December last year, Norges Bank cut the key policy rate by 0.25 percentage point to 1.25 percent. In our assessment, Norges Bank gave weight to the weakening of the growth outlook for the Norwegian economy and attached importance to countering the risk of a pronounced downturn due to lower oil prices.

Last week, Norges Bank presented its latest Monetary Policy Report with updated projections for developments in the Norwegian economy and a new assessment of the orientation of monetary policy.

Developments in the Norwegian economy this winter have been broadly in line with expectations. Inflation remains close to 2.5 percent and unemployment has remained stable. So far, the effects of the fall in oil prices on the real economy have been relatively small.

However, the outlook for the Norwegian economy has weakened somewhat. Oil prices have continued to fall and activity in the petroleum industry appears to be declining more than previously assumed. Wage growth in 2014 was lower than projected and there are prospects that wage growth will also be lower ahead than projected earlier. This will lead to lower inflation further ahead.

At the same time, house prices continue to rise rapidly. This may increase household vulnerability and may trigger or amplify an economic downturn further ahead.

The Executive Board decided to keep the key policy rate unchanged at 1.25 percent. If developments in the economy ahead prove to be broadly as projected, there are prospects that the key policy rate will be lowered.

The analysis in the Report suggests a key policy rate of approximately 1 percent in the coming years, followed by a gradual increase. The analysis suggests that inflation will increase somewhat in the coming quarters before edging down and lie slightly above 2 percent later in the projection period. Capacity utilisation in the mainland economy is projected to decline further, before returning to a more normal level.

Let me summarise. After the global financial crisis, the Norwegian economy quickly rebounded, supported by robust public finances and strong growth in the petroleum sector. Since last summer, oil prices have fallen. Activity in the petroleum sector has probably passed the peak. So far, the impact on the real economy has been modest. At the same time, the Norwegian economy is facing new challenges. Vulnerabilities established during the golden years must be addressed. From being in a unique economic position, Norway is now headed for a period of restructuring.

Norway's starting point is favourable. Inflation is well anchored and the krone is functioning as a stabiliser. In addition, we have been able to transform oil in the ground into financial wealth in a period when oil prices were high. We have significant fiscal leeway. But the conditions and forces necessary for growth in the economy in the longer run will have to be brought more into line with those of other countries.

Thank you for your attention.