Svein Gjedrem: The economic situation in Norway

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, 21 March 2002.

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

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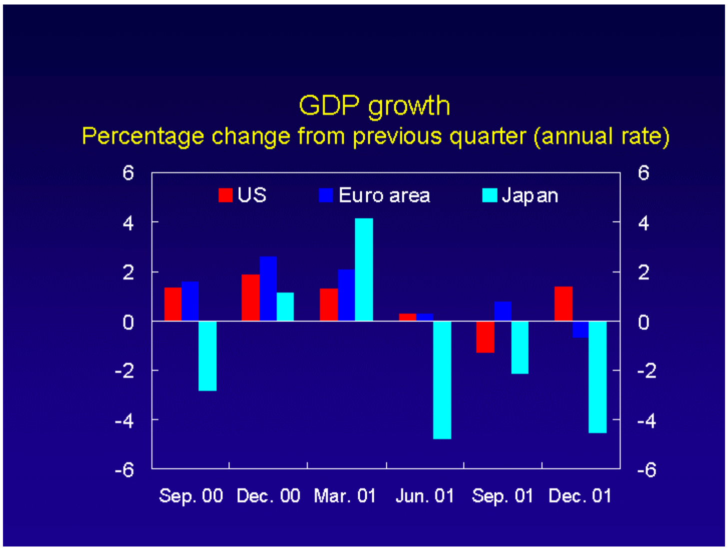
Your Excellencies, ladies and gentlemen

The economic outlook



The world economy has been experiencing a slowdown. Economic growth stagnated in the US and the euro area in the last three quarters of 2001. Growth remained somewhat firmer in the UK, but was moderate towards the end of the year. GDP has fallen in Japan.

In most countries, public and private consumption fuelled growth in demand, while a fall in capital formation and inventories has exerted downward pressure. Growth in the US economy came to a halt last spring. Overinvestment, particularly in IT and telecom equipment led to low returns on capital and reduced corporate earnings. The stock market declined when growth prospects were revised. The unemployment rate rose. Terrorism and war added to the uncertainty.

The US economy is flexible and seldom remains in recession for a long period. There are some signs of an early recovery. Monetary policy and fiscal easing have supported continued growth in private consumption. Equity prices, commodity prices and long-term interest rates have picked up since the sharp decline following the events of September 11.

Oil prices plunged by around 40 per cent between autumn 2000 and the end of 2001. Developments towards the end of last year were marked by lower demand for oil. In December, the OPEC countries together with Russia, Mexico and Norway decided to limit oil production. This may have contributed to increasing the oil price during the last months. The risk of war in the Middle East and the decline in commercial oil stocks in the US may also have contributed to increasing the oil price.

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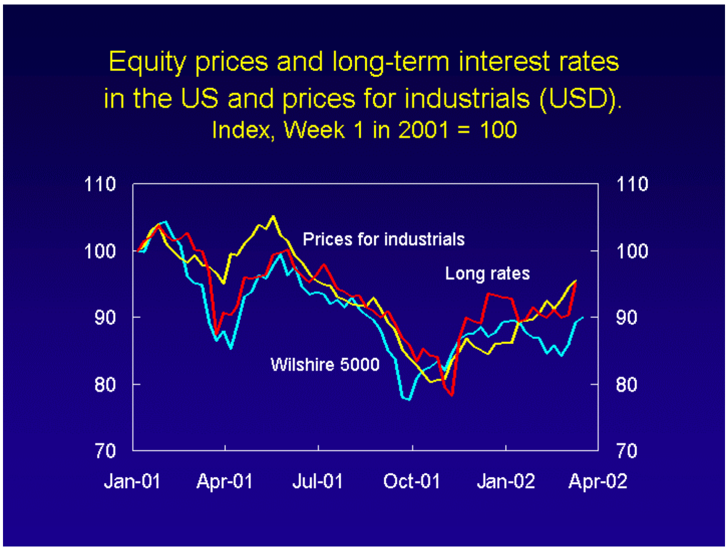
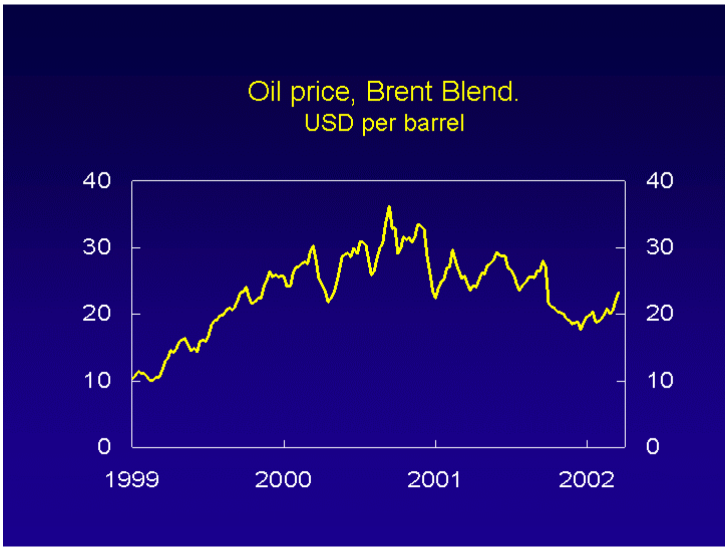
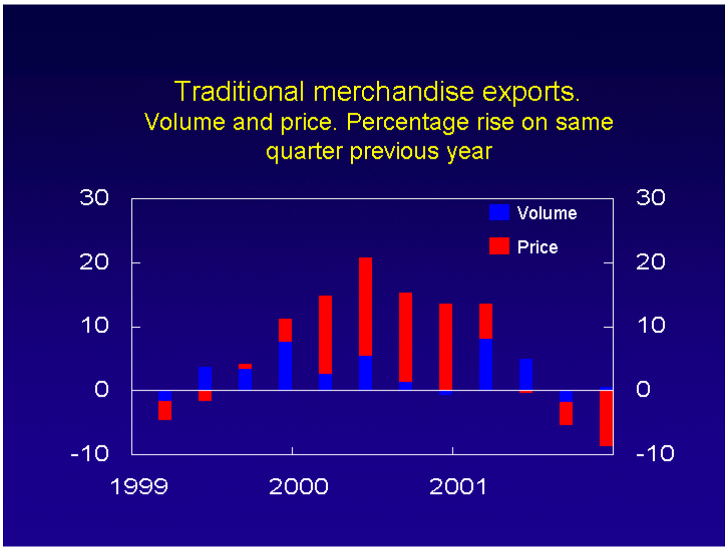
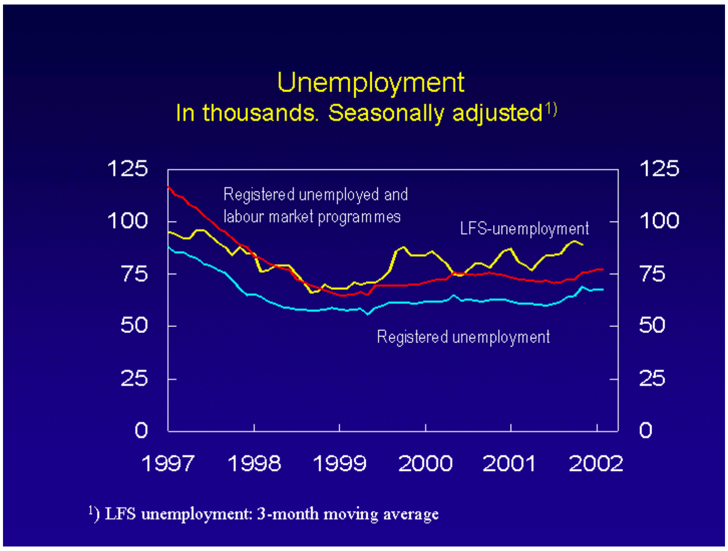

Equity prices and long-term interest rates
in the US and prices for industrials (USD).
Index, Week 1 in 2001 = 100
110
100
90
80
70
Prices for industrials
Long rates
Wilshire 5000
Jan-01
Apr-01
Jul-01
Oct-01
Jan-02
Apr-02

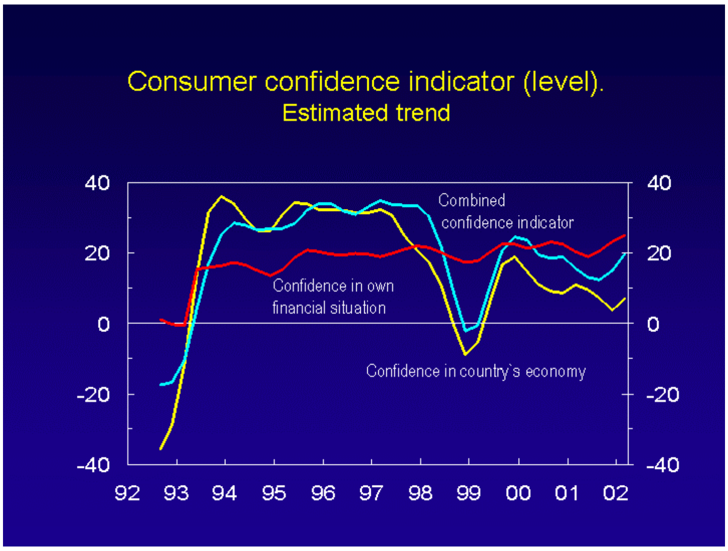

Oil price, Brent Blend.
USD per barrel
40
30
20
10
0
1999
2000
2001
2002


Traditional merchandise exports.
Volume and price. Percentage rise on same
quarter previous year
30
20
10
0
-10
Volume
Price
1999
2000
2001

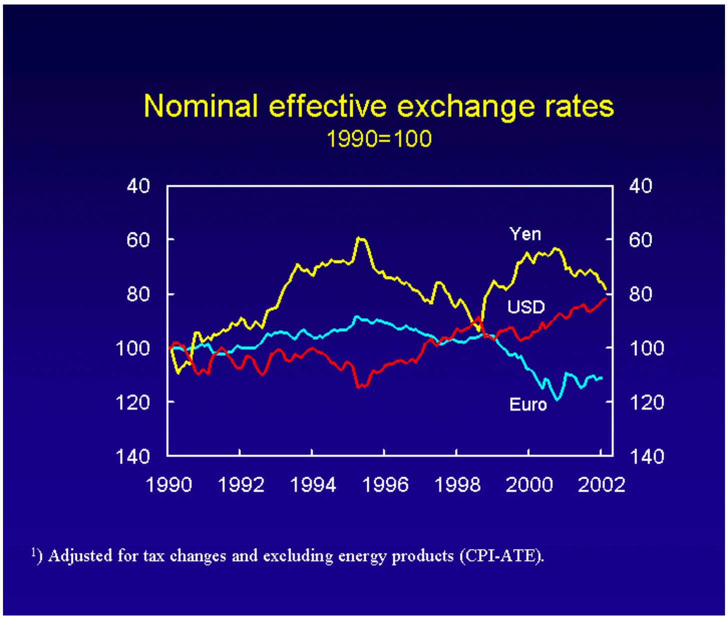
The global slowdown started to have ripple effects on the Norwegian economy during autumn and winter. Prices for important Norwegian export products fell, and markets for many export industries have weakened. Salmon prices dropped by close to 20 per cent in 2001, after reaching record levels the previous year. The trade policy in the EU stipulates a minimum price for salmon exports, to the benefit of ineffective and high cost producers. The volume of traditional exports fell in autumn last year. Fish, iron and steel exports showed the steepest declines.



Employment stagnated early last autumn, but picked up again towards the end of the year. Unemployment edged up somewhat in the latter half of 2001, but has remained low. In February 2002, registered unemployment was 3.1 per cent, or 0.3 percentage points higher than one year earlier.



Norwegian households seem relatively unaffected by the international downturn. Overall consumer confidence rose sharply in the first quarter of 2002, back to the level recorded early in 2000. Households' confidence in their own financial situation remained high throughout the autumn, reflecting solid growth in real disposable income and a comfortable net asset position.



We estimate that price inflation, with unchanged interest rates, will be 2½ per cent two years ahead. The overall uncertainty surrounding the inflation projection is illustrated in this chart. On the whole, the risks seem balanced around our central projection of 2½ per cent.

Norway's real disposable income is highly affected by export prices. As most of the income from exports of oil and gas is transferred to the Government Petroleum Fund, the effects of the global downturn on the activity level in Norway have been limited. The Norwegian economy may weather the downturn without any substantial impact on the level of activity or employment, but with a continued risk of high growth in labour costs in the business and public sectors.

Economic policy

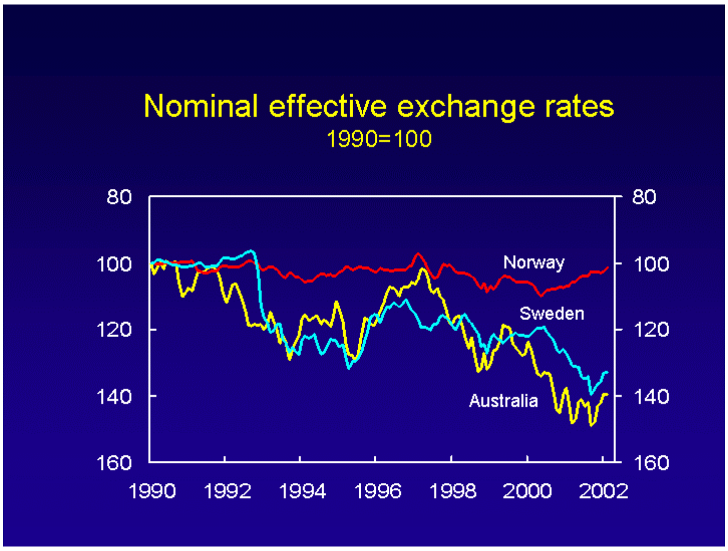
The guidelines for economic policy were revised last year. Henceforth, the real return on the Government Petroleum Fund shall be used over the central government budget. Central government petroleum revenues shall continue to be transferred to the Government Petroleum Fund and invested abroad.

Monetary policy in Norway is oriented towards low and stable inflation. Since March 2001 the inflation target is set at 2½ per cent. When monetary policy is oriented towards stabilising inflation, it also contributes to stabilising aggregate demand and output. The inflation target is the nominal anchor for the Norwegian economy.

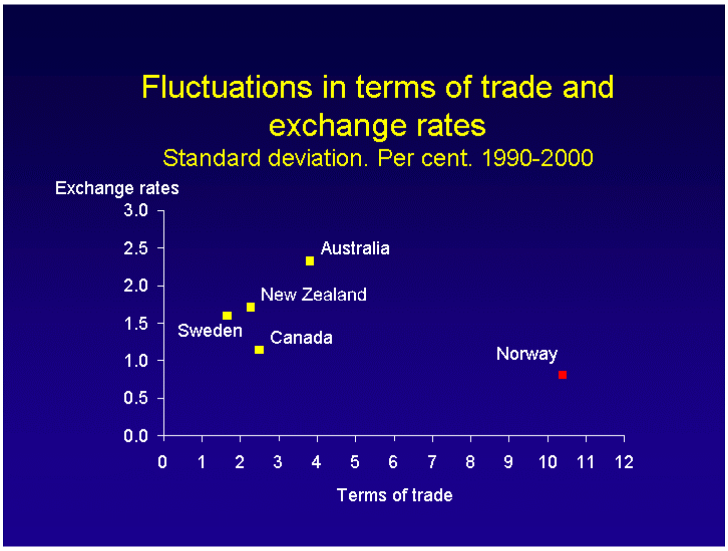
Low inflation is the objective and the interest rate is the instrument. If it appears that inflation with unchanged interest rates will be higher than 2½ per cent, the interest rate will be increased. If it appears that inflation with unchanged interest rates will be lower than 2½ per cent, the interest rate will be lowered. Low and stable inflation will be a fixed feature of economic developments. This is something that the social partners, businesses, borrowers and investors in property and securities can take as a given.

From 1986, changes in the exchange rate or the prospect of changes in the exchange rate had implications for interest rates. A stable krone exchange rate was the nominal anchor. In Norway, this has been reflected in wage determination because labour cost developments among trading partner countries have been an important reference.

Exchange rates between major international currencies fluctuate widely. The US dollar has appreciated by more than 30 per cent since 1995. The German mark – the euro since January 1999 – has depreciated by about the same between 1995 and autumn 2000. The Japanese yen has been particularly volatile.



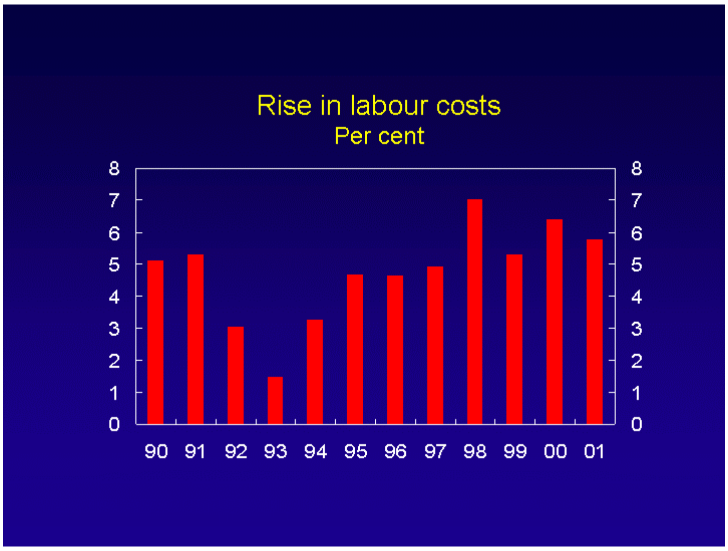
Smaller countries have also experienced fairly wide exchange rate fluctuations. The Swedish krona has depreciated by more than 10 per cent since summer 2000. The Australian dollar has weakened by over 30 per cent since spring 1997. The UK, Canada and New Zealand have also experienced wide exchange rate fluctuations. The Norwegian krone exchange rate, on the other hand, has been relatively stable.



Countries whose exports include a large component of raw materials tend to experience considerable volatility in their exchange rate. Australia is one example. Fluctuations in commodity prices entail changes in countries' terms of trade, which measures the ratio of export to import prices. Changes in the terms of trade have an impact on the exchange rate, which in turn curbs the effects of changes in commodity prices on profitability in the business sector. Hence, the exchange rate serves as a buffer against changes in the terms of trade.

Norway's terms of trade also fluctuate considerably, primarily reflecting changes in oil prices. However, a substantial portion of petroleum revenues is invested in foreign equities and bonds through the Government Petroleum Fund. Changes in oil prices influence the size of the Fund, but have little effect on the use of petroleum revenues at home. The Government Petroleum Fund thus serves as a buffer against swings in the oil price, and thereby stabilises the krone exchange rate.

The Norwegian economy may nevertheless be exposed to disturbances of a type that cannot be absorbed by the Petroleum Fund. In the future, fluctuations in the value of our currency will probably be more in line with the fluctuations observed in other countries. The exchange rate will vary.



The increase in labour costs is important when Norges Bank's assesses the outlook for price inflation and sets interest rates. Since 1997, labour costs have increased annually by between 5 and 7 per cent. In spite of this, consumer price inflation has been close to 2½ per cent over the past few years. The krone exchange rate has appreciated as a result of a wider interest rate differential between Norway and other countries. Combined with low growth abroad and increased trade with low-cost countries such as China, this led to a slower rise in import prices.

In Norway, Voluntary Export Restraints on clothing have been removed and tariffs on clothing have been reduced considerably. In the EU and the US, a similar tendency has not been seen to the same extent. This may explain why prices for clothing have fallen in Norway relative to the EU and the US. However, there is still a long way to go before restrictions on clothing imports to Norway are entirely dismantled. For example, there is a duty today on imported children's clothing and on shirts, suits, jackets and trousers for men and boys.

As the world economy recovers, import price inflation will edge up. A rise in labour costs of more than 5 per cent will then only be consistent with the inflation target if the krone continues to appreciate.

In the long run, wages must be compatible with the value added that is generated by workers, i.e. labour productivity. Over time, the increase in real wages is therefore determined by developments in labour productivity. In Norway, productivity growth has averaged 1½-2 per cent over the last 20 years. If this continues to be the case, an increase in nominal labour costs of around 4-4½ per cent in the long term will be consistent with the inflation target.

There is an important interaction between monetary policy and fiscal policy. According to the guidelines for fiscal policy, petroleum revenues are to be phased in approximately in pace with the expected real return on the Government Petroleum Fund. This guideline implies that fiscal policy will contribute to stimulating aggregate demand in the Norwegian economy every year for many years ahead. The guideline also implies that the use of petroleum revenues will increase as long as the Petroleum Fund is expanding.

Variations in oil prices are accompanied by considerable fluctuations in government petroleum revenues from one year to the next. It is important to prevent these fluctuations from spilling over to the mainland economy. Public expenditure and taxes that vary in relation to oil prices would result in an unstable economic environment. Financial markets would be marked by uncertainty and turbulence, with an increase in the risk premium on Norwegian securities. This would have resulted in higher and more variable interest rates. The risk of financial crises in Norway would also have increased because the cyclical fluctuations in the Norwegian economy would have been more pronounced. It is therefore an advantage that fiscal policy is now predictable and anchored in a long-term strategy.

The future size of the Petroleum Fund depends on oil price developments. The guideline ensures that we only use the return on wealth that has already been accumulated. This makes policy robust to changes in oil prices and ensures that petroleum wealth will be of benefit both today and in the future.

The guideline provides a framework that contributes to making the central government budget an appropriate tool for setting political priorities. It sets a limit on the share of petroleum revenues that the government can use each year and does not distinguish between domestic and foreign spending. This eliminates the waste of resources that two separate budgets would necessarily entail.

The government invests petroleum wealth in foreign securities through the Petroleum Fund. Government wealth is thereby more diversified. These investments have no impact on the Norwegian capital market. Both mainland private saving and business fixed investment have been high in recent years. In Norway, credit and capital markets nevertheless feature some weaknesses, with thin securities markets and a narrow investor and ownership base compared with other countries. The reasons, and hence the solutions, can probably be found in the structure of the taxation of dwellings, property and financial assets, in a high level of state ownership of enterprises and in the organisation of pension saving in Norway. Investing even more government capital in Norway would reduce the return on investments in the Norwegian business sector and prompt other investors to invest elsewhere. Allocating even more capital to the Norwegian economy would probably lead to a rapid relocation of jobs to other countries, as the krone would tend to appreciate.

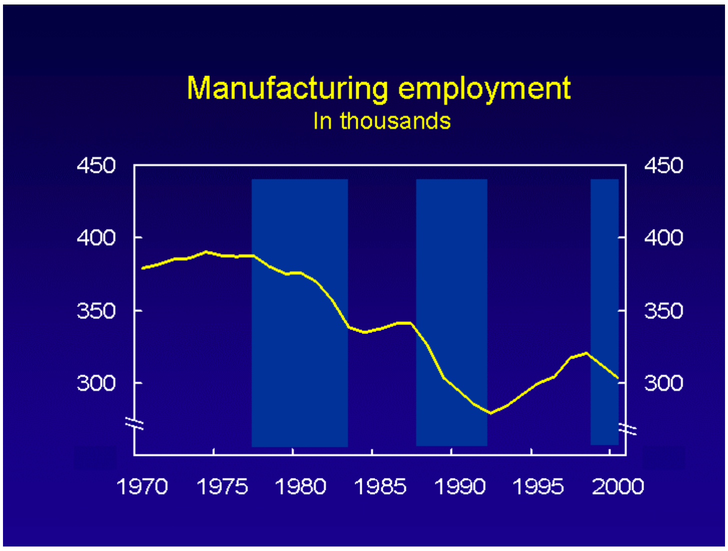
Effects on industry structure

The planned use of petroleum revenues will increase demand for public and private services. The guidelines imply an increase in the use of petroleum revenues over the central government budget of around 3½ per cent of mainland GDP by 2010. This may add 2½ -3 per cent of total employment in the service sector. As long as there are labour shortages in Norway, a comparable decline in manufacturing employment is likely to occur.

Although the phasing in of petroleum revenues is a gradual process, the contest for labour resources will intensify. As a result, monetary policy is likely to remain fairly tight in the years ahead. A high interest rate level may in periods result in a strong krone. This may accelerate the scaling back of manufacturing industry. However, in the long run monetary policy cannot influence overall employment or its distribution across industries. A lower interest rate would have resulted in higher price and cost inflation, which would also have weakened profitability in the manufacturing sector. The end result would have been the same for employment and production, but in addition we would have had to face the costs of high inflation.

Even if employment and production in manufacturing are affected, the situation for Norwegian enterprises will not necessarily be negative. Some enterprises could be at the forefront of technological developments and increase efficiency in pace with the relatively high rate of growth in real wages in Norway. In recent years, we have also seen that many enterprises have moved large portions of their production abroad, particularly the most labour-intensive production. Norwegian manufacturing companies could therefore remain profitable even if the size of the manufacturing sector in the Norwegian economy is reduced. However, the scaling back of manufacturing also involves a risk. It makes the economy more vulnerable. The growth potential of the economy – the basis for learning, innovation and development – may be impaired when less of the business sector is exposed to intense foreign competition.

Over the last thirty years, manufacturing industry has been scaled back in waves. The sharpest declines were observed in the years between 1977 and 1984 and from 1987 to 1992. The declines were preceded by a fall in profitability in this industry. It may take time for a weakening to spill over to output and employment, but when the turnaround first occurs it takes place rapidly and on a large scale. Primary industries, in contrast, are scaled back gradually. These developments will take place in addition to the effects associated with the increased spending of petroleum revenues. All in all, employment in manufacturing and agriculture may fall by 2 - 5 per cent of total employment in the period to 2010. Employment in manufacturing may drop towards 10 per cent of the total. Agriculture may employ less than 2 per cent of total employment.

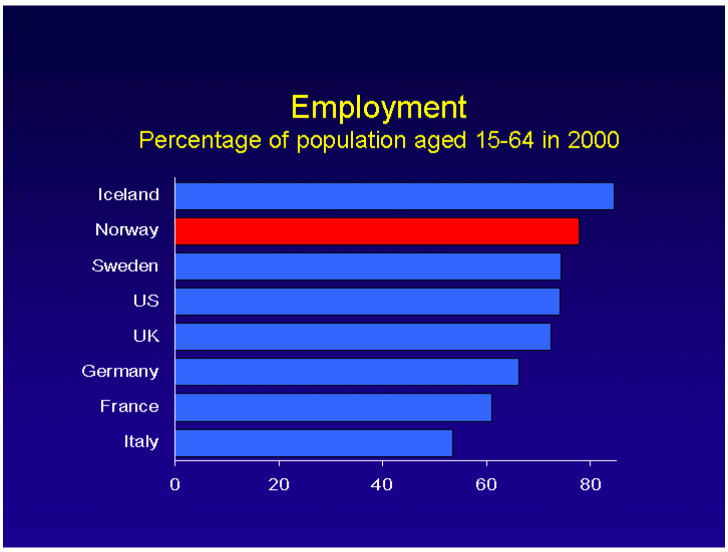


Changes in industry structure, with an increase in the number employed in services and a decrease in manufacturing, will probably reduce the role of pay increases in manufacturing as a benchmark for wage determination. Among many of Norway's trading partners, similar developments have occurred. However, the share of employment in manufacturing and agriculture in Norway is already relatively low.

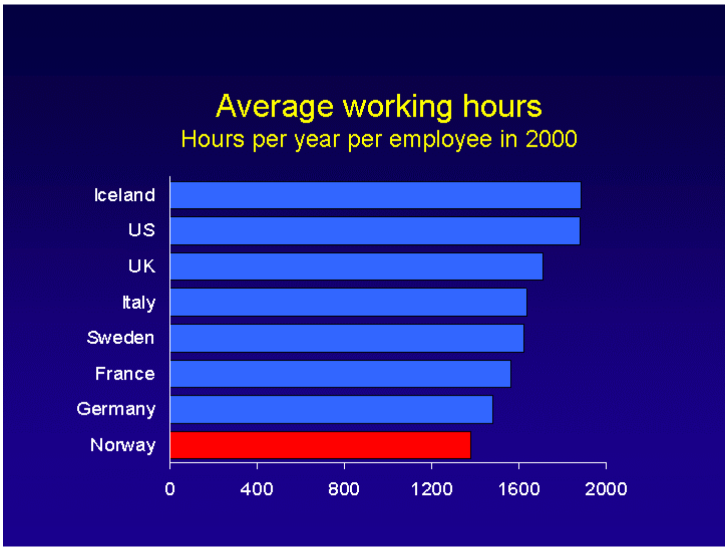
Pensions

While high oil prices have resulted in sizeable revenues and surpluses on the current account and government budgets, growth in mainland output has been low over the last three years, at only 1 ¼ per cent per year. The sluggish growth rate may be attributed to the supply side of the Norwegian economy. Extensive labour reforms have limited the supply of labour. Measured by person-hours, employment has fallen by 0.4 per cent annually in this period. At the same time, labour shortages have persisted in many sectors and overt unemployment has been stable and low.

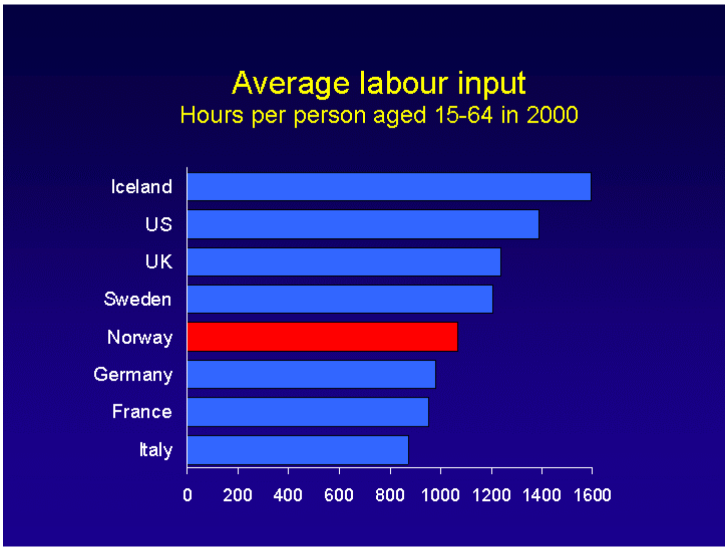
The business sector must restructure rapidly when real wages increase sharply. Many activities will no longer be profitable and will be shut down. This could lead to higher unemployment. However, lower employment will not necessarily be reflected in unemployment figures. We may instead see a flow of discouraged workers into, for example, disability pensions, early retirement schemes or different types of adjustment packages. The extent to which these schemes are used will depend on financial incentives and entitlement thresholds.



In Norway, the employment rate is among the highest in the OECD area. This reflects both high labour force participation and low unemployment.



The picture becomes more mixed when average working hours are taken into account. The average is lower in Norway than in other countries. The sickness absence rate is high. Part-time employment is widespread.

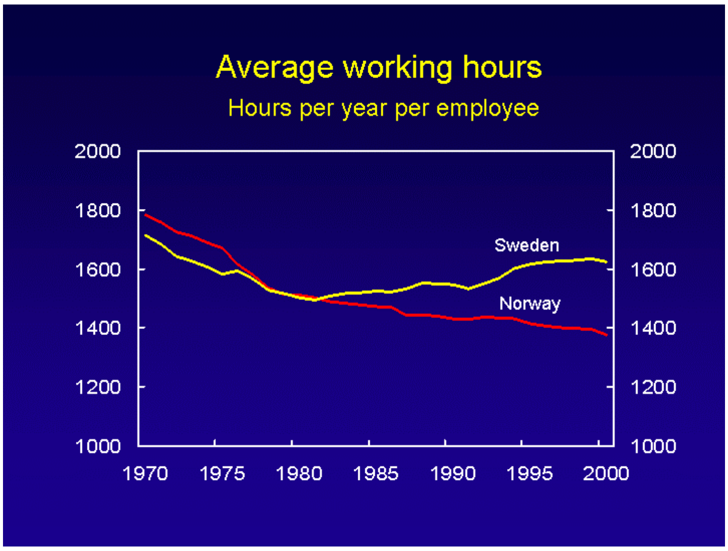


The average number of person-hours worked in the working-age population is relatively low, despite high labour force participation and low unemployment. Among OECD countries, the only countries with lower figures than Norway are those with very high unemployment.

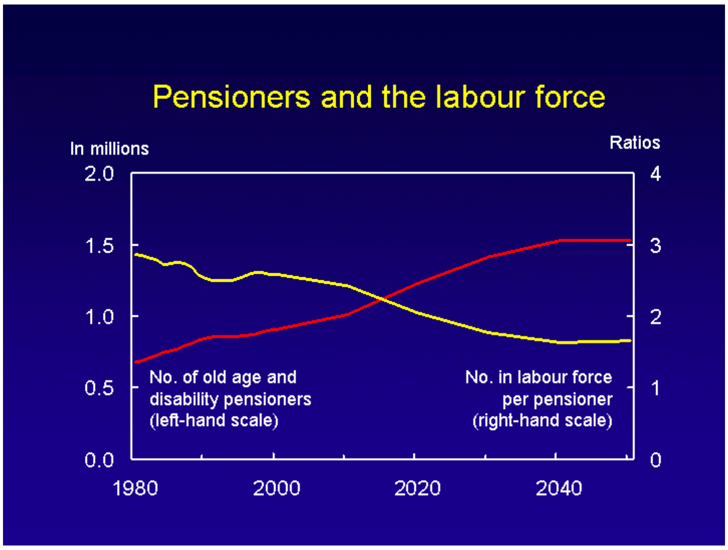
In Norway, average working hours have fallen by more than 20 per cent in the last thirty years. This can be partly explained by the way working life and child care are organised, but similar trends are also seen in many other countries, especially in Scandinavia.

We cannot simply assume that people want to work more, even if an increased labour input will result in higher income and greater prosperity. It is natural to use some of the increase in prosperity for leisure. The considerable share of part-time employment may reflect choices that individuals do not necessarily want to change.

On the other hand, if we increase our labour input to the level in Sweden, without reducing productivity, our future income would increase by more than the increase resulting from a doubling of our petroleum wealth.



The structure of the tax and pension system influences the choice between work and leisure. Lower tax rates on employment income could boost labour input. The pension system is also of significance to labour input, as it influences employers' labour investment decisions.

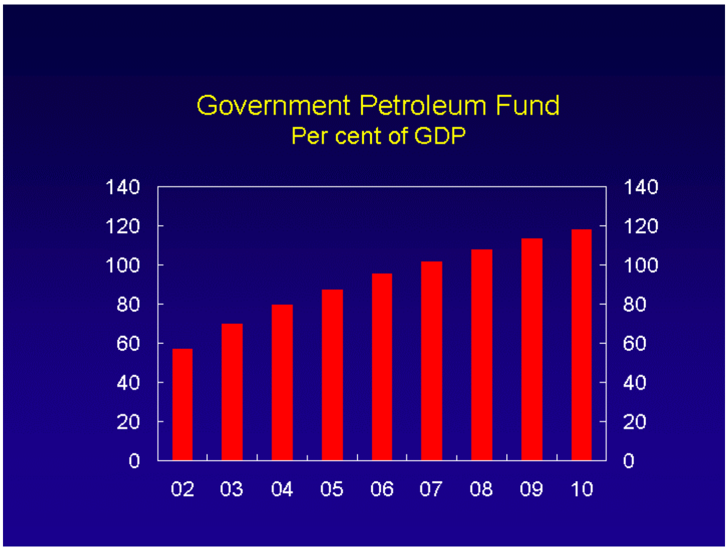


The expansion of the labour force is coming to a halt. At the same time, the number of old-age and disability pensioners is rising rapidly. Twenty years ago, there were nearly three persons in the labour force for every pensioner, whereas in 20 years, there will be fewer than two.

Although life expectancy is high, the average retirement age in Norway is steadily falling. For men over 50, the average retirement age fell from nearly 67 in 1970 to a little more than 63 at the end of the 1990s. For the entire labour force, including all age groups, the average pension age in the National Insurance Scheme was down to 58.

Flexibility in working hours and in the retirement age gives each worker the opportunity to choose between work and leisure. This freedom to choose is a benefit in itself. However, the terms - wages, working hours and pension schemes - should reflect the value added of labour. Pension benefits should therefore depend on how long each person chooses to remain in employment.

Many countries have evaluated and some countries have worked out changes in their pension systems to cover a higher portion of pension expenditure through accumulated capital, i.e. a funded system. Sweden has recently implemented a pension reform that ensures that annual pension benefits increase in relation to the number of years the person has worked. At the same time, an increase in life expectancy for each age group will reduce the annual pension. This motivates the person to remain in employment and helps to ensure that the system is sustainable.



Due to the duration of the transfers to pension reserves in Sweden, the replacement of the former pension system by the reformed one requires a transitional period over several years. In Norway, the surpluses on the current account and the Government Petroleum Fund simplify any replacement of today's pension system by a funded pension system.

Labour is our most important resource. The decline in average hours worked cannot continue if we are to have a sustainable pension system. The current evaluation of our public pension system must focus on the incentives to work and the effects on the average retirement age. A fund-based system may be an appropriate approach and at the same time make pension savings transparent for each individual. This may in itself provide an incentive to increase working hours.

Thank you for your attention.