Øystein Olsen: Economic perspectives

Address by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), to foreign embassy representatives, Oslo, 8 April 2019.

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Accompanying slides of the speech.

Your excellencies, ladies and gentlemen.

Firsts of all, I would like to thank you for taking the time to attend this event, which provides me with an opportunity to present Norges Bank's view of the economic situation and some of the challenges ahead.

International economic cooperation is creaking

Throughout history, technological innovation and increased trade in goods and services have been important sources of growth and development. The two driving forces have functioned in tandem. Trade barriers have been reduced in recent decades. Faster transport and advanced communications systems have greatly facilitated access to broader markets. Global value chains have emerged, and service providers can be located far from customers. With free-flowing capital, we can invest globally.

Chart: World trade has grown markedly

Since the 1970s, world trade has grown rapidly. As a percentage of world GDP, international trade has almost doubled. A number of new countries have also increased their share in world trade.

A more closely integrated world economy has facilitated specialisation, innovation and better use of local resources. The room for exchanging ideas and knowledge has expanded. Increased competition and innovation have gone hand in hand.

Chart: Trade gives Norway opportunities

Efficient global trade is particularly advantageous for small open economies, like Norway. Norway has benefitted greatly from the opportunities afforded by trade with other countries.

It is almost impossible to imagine today's welfare level without the specialisation brought about thanks to a world of open borders. Norway exports a limited range of goods and services to the world market. This allows us to finance imports of numerous finished goods, which are cheaper than if we had manufactured them at home. Labour is thereby freed up for use in education, health and other services.

Access to capital and technology abroad has enabled us to develop new industries based on domestic natural resources. Hydropower and the oil industry are prime examples. We now invest our petroleum wealth in capital markets. The Government Pension Fund Global (GPFG) allows Norway to take a share in global value added.

We need other countries – more than they need us.

The foundation for today's global trade cooperation was laid in the years following the Second World War. Institutions such as the IMF and the World Bank fostered closer economic cooperation between countries. The ratification of the General Agreement on Tariffs and Trade (GATT) marked the beginning of a gradual reduction of tariff barriers, which culminated in a rule-based, multinational trade system under the aegis of the World Trade Organization (WTO).

History has shown that the trend towards a more open and liberal world order can reverse, as seen in the interwar period. This may now be happening again.

Brexit, the UK's exit from the EU is the first major setback for European integration in several decades.

The scaling back of tariffs has stopped, and new tariff barriers are being erected. At the same time, the WTO's position has weakened, making it more difficult both to resolve disagreements and carry out needed regulatory reforms.

Last year was marked by trade tensions between the United States and China. The United States raised tariffs on a range of imports, and China retaliated in kind.

Protectionism means reduced growth capacity, putting at risk the gains brought about by open borders. If the world enters a new period of rising trade barriers, a prime engine of growth and development may lose its momentum.

The most serious consequences of new tariff barriers will be faced by developing countries. The WTO has more than 160 member countries. Many of the new countries have experienced rapid growth. Substantial technological and economic gaps have been reduced. Living standards have improved for large population groups.

But not everyone has reaped the gains associated with globalisation and trade. Some have lost. Inequalities have widened. This explains to a large extent the opposition to globalisation and international cooperation.

Chart: China exports more advanced products

The current trade tensions are also about power and influence. Many Asian countries are emerging as important drivers of the digital economy. China is rapidly adopting artificial intelligence and using big data. Exports are shifting from simple to more complex products.

China is now the world's next largest economy[1] and is competing with advanced western countries in many arenas. This has prompted discussions about market access, intellectual property rights and trade balances.

Global economic integration is not straightforward, but the shortcomings in today's framework for global trade must be dealt with through reform and not increased protectionism. New barriers will not help poor regions or those that have been left behind in western economies.

For Norway, exports of goods and services account for more than a third of GDP. Norwegian businesses are part of global value chains. This means that protectionist measures can spill over into the Norwegian economy even if Norway is not directly targeted.

Chart: We trade mostly with the EU

The international framework and trade agreements we have with other countries are essential to the Norwegian economy. The EEA agreement is of particular importance.

Thanks to the free flow of goods, services, labour and capital within the EEA area, Norway's domestic market is about 100 times bigger than it would have been otherwise. A good half of our trade with other countries is with EU countries (Chart 5). Common regulations and product standardisation facilitate market access for Norwegian firms.

Norwegian business and industry may soon feel the consequences of Brexit. The UK is an important trading partner. The UK's exit from the EU means it will also exit the EEA agreement, creating uncertainty for many firms.

At the same time, international economic cooperation is creaking. In the years ahead, the multilateral trade system is at risk of being undermined, which may leave us with a more fragmented system. This may adversely affect small countries in particular. In that situation, it would be injudicious for Norway to compromise its current agreements with Europe.

Climate change requires structural adjustments

The world needs more cooperation, not less. We are facing a climate crisis that can only be addressed by engaging in a common global effort.

Last year's report from the UN climate panel was alarming. If work to reduce greenhouse gas emissions is not intensified, global warming could spin out of control. A warmer planet will have serious consequences.

Major changes in production methods and consumption patterns are needed in order to mitigate global warming. Measures taken must lead to concrete reductions in global emissions and should be cost-efficient.

Emissions pricing is essential to reducing greenhouse gas emissions. The polluter must pay. The consequences of not having applied this principle at a global level are now coming into evidence. To quote one of last year's Nobel laureates in economics, William D. Nordhaus: "The result is too much burning of fossil fuels, too much climate change, and too many harms to humans, wildlife, ecosystems, and more."[2]

It is a demanding task to put into place adequate measures. The gains from lower emissions are shared by all - also by those who do not contribute. This creates a free-rider problem both at the global and national level. Moreover, there is opposition to environmental taxes, not only among low-income groups. Subsidies and support are more readily embraced – and thus tend to be favoured by policy-makers even if their effect on global emissions often does not justify the cost.

An international emissions trading system could ensure equal pricing of emissions across countries and sectors. At a global level we have not reached this goal, but important progress is being made.

The EU Emissions Trading System and national taxes together cover much of the greenhouse gas emissions in Europe. In Norway, over 80 percent of these emissions are covered by emission allowances or taxes.

Chart: Higher prices for European CO2 emissions

The price of emission allowances in the EU has long been so low that the emissions trading system has been of marginal consequence. But allowances are now being removed from the market. This has led to a fivefold price rise. The system is beginning to work.

The shift towards a greener and more sustainable economy places heavy demands on businesses and investors, but also creates opportunities.

Technological advances and innovation are necessary for achieving more sustainable economies. Economic instruments such as emission allowances and taxes make the quest for new solutions profitable. Climate policy has already led to rapid progress in the area of solar, wind and battery technology. Old, polluting equipment is gradually being replaced by new, cleaner and greener technology.

At the same time, climate change entails new risks for business and industry. Climate risks include the impact of climate change, uncertainty surrounding future climate policy and potential disruptive technologies.

Expected return and risk are influenced by firms' response to potential structural changes. That is why many investors require companies to report on climate issues, as has the GPFG. Managing climate risk is part of the systematic work in the area of responsible investment.

Financial investors must manage climate risk on a par with other risks. Virtually all economic activities lead to emissions, either directly or from complex production chains. Climate risks are therefore difficult to isolate and quantify, both at firm and sector level.

Identifying the winners in the green transition is also a demanding exercise.

The financial sector has to adapt to climate risk, but does not have effective tools to contribute to solving the climate problem. Also, it is doubtful whether defining emissions from sectors or individual businesses as unethical will make a difference. The responsibility for measures to combat global warming must rest with the authorities. The solution lies in economic instruments that promote structural change.

Structural change generates growth

A shift in consumption patterns and production methods towards lower emissions will reduce demand for fossil fuels. This can influence oil and gas activities in Norway. We have always known that oil and gas activities will be phased out sooner or later. Oil and gas are non-renewable resources. A stricter global climate policy may mean that this will occur sooner than foreseen earlier.

Chart: Important role for Norwegian gas

But Norwegian oil and gas production will, most likely, remain profitable for quite some time. The supply of clean energy is still limited. Today, coal accounts for a large share of global energy demand. Demand for natural gas may increase as countries move towards a greener economy. In Germany and Poland, phasing out coal faster than planned is being discussed. Norwegian gas can play an important role in a transition phase.

There is still global demand for oil and gas. If we reduce production on the Norwegian shelf earlier than planned, other suppliers are ready to take over. The climate impact of an earlier reduction would therefore be marginal, while the costs to Norway would be substantial.

The oil industry has been an economic engine for Norway for close to 50 years. The revenues from this industry have improved the welfare of today's citizens and the citizens of tomorrow. The spillover effects from the oil sector to the wider Norwegian economy are substantial. Throughout our country there are oil-related jobs to be found. More than 10 percent of all employed persons in Norway are either directly or indirectly working for the oil industry.[3] Innovation and skills development in the industry have also benefitted other sectors.

The oil industry has been through a demanding period of personnel cuts, cost savings and rationalisation. The restructuring in the industry that was already underway became even more pressing when oil prices collapsed in 2014. Today, oil companies are hiring again, and will likely continue to do so in the coming years. But we must be prepared for a time when the industry is no longer expanding, but gradually declining, and we will need growth in other industries.

The business sector must drive structural change and innovation, but the authorities can provide favourable operating conditions to promote an innovative and sustainable business sector. Norway ranks high on the ease of doing business index[4], supported by solid institutions, a high degree of confidence and a solid welfare system.

History has shown that Norwegian business and industry have a strong capacity to adapt. Many of today's oil service operators had a long history in other industries before moving into the oil sector. A prime example is the shipbuilding industry, which faced a sharp drop in demand for ships in the 1970s. The industry had resources and skills that could be reoriented to production of platforms and other inputs in the oil industry.

Companies in other industries have also seen the opportunities afforded by new technology or changes in operating conditions

Chart: Employment shifts towards services

Norway's industry is undergoing structural changes. In the past decades, the manufacturing industry has continued to decline, reflecting increased automation and relocation abroad. Increased prosperity has generated more demand for both private and public services. Employment has shifted towards the service sector.

Chart: High productivity in retail sales

The service industry has reaped gains in the form of increased productivity through restructuring and adoption of new technology. The banking industry was among the first to do so. The retail trade sector has grown in recent decades without any notable increase in employment. Productivity growth has been high. Use of new technology and the shift away from private shops to chain stores have reduced distribution and administration costs. Digital technology is now driving yet another shift, towards online shopping.

In other areas, intermediaries are changing or disappearing. Travel, cinema tickets and doctor appointments are bought or made online. Government agencies, banks and insurance companies are offering more and more do-it-yourself online services.

Restructuring involves job losses, with potentially painful consequences for those affected. But over time labour is made available for employment in other better-paid jobs, generating gains in the form of cheaper goods and services. Structural change is the basis for growth and welfare.

Monetary stability

Let me turn to the current situation and outlook for the Norwegian economy.

Chart: Stronger upturn in the Norwegian economy

In September 2018, Norges Bank raised the policy rate for the first time in seven years, reflecting the favourable developments in the Norwegian economy. In March this year, the bank raised the policy rate further. The rate is now at 1 percent.

Growth in the Norwegian economy has been solid since autumn 2016. Employment has risen, and unemployment has declined. The global upturn, higher oil prices and low interest rates have contributed to pushing up growth. After falling sharply for several years, investment on the Norwegian shelf and oil service exports expanded last year.

A number of signs indicate that capacity utilisation has continued to rise in recent months. The number of employed persons as share of the working-age population has increased, and unemployment has drifted down further. There is also an increase in the number of enterprises reporting capacity constraints.

Chart: Inflation has risen

Consumer price inflation has increased over the past year, partly reflecting higher wage growth. Tighter labour market conditions suggest that wage growth will increase further.

The risk outlook is dominated in particular by the global developments mentioned. Over the past year, rising protectionism and political uncertainty have weighted on global growth. The UK's relations with the EU have yet to be clarified. If trade tensions deepen, growth among trading partners may be lower than projected. At the same time, the krone may remain weak, if global uncertainty persist.

The target for monetary policy is annual consumer price inflation of close to 2 percent over time. Inflation targeting shall be forward-looking and flexible, so that it can contribute to high and stable output and employment and to countering the build-up of financial imbalances.

At its meeting in March, the Executive Board noted that the monetary stance in Norway is accommodative. Underlying inflation is a little higher than the inflation target. Capacity utilisation appears to be slightly above a normal level. The upturn in the Norwegian economy is expected to continue, partly fuelled by strong pick-up in investment on the Norwegian shelf in 2019. Further out, lower growth abroad and a decline in petroleum investment will weigh on growth.

Chart: The Executive Board's assessment and interest rate forecast

The Board decided at the meeting to raise the policy rate to 1 percent. The assessment of the outlook and the balance of risks suggested that the policy rate will most likely be increased further in the course of the next half-year.

Conclusion

To wrap up, globalisation, digitalisation and structural changes are facets of the same long-term trend – we are in the midst of a technology-driven growth process that encompasses much of the world. It is easy to focus on the negatives, but we must also keep our eyes fixed on the big picture: never before have so many taken part in a journey with such a great leap in prosperity.

But growth is unevenly distributed. The winners in global competition are reaping substantial rewards, while broad categories of wage earners in the traditional industrial economies have been left behind. The harmful effects of rising inequality must be taken seriously. We, the grown-ups, should also listen to the message sent from our youngsters. They demand that the world's leaders take the climate threat seriously and put in place efficient climate policies.

Let's hope that trends that now appear to be leading us in the wrong direction can change course.

Thank you for your attention.

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1 Based on GDP at market rates.

2 Nordhaus, W. D. (2018): Speech delivered at the Nobel Banquet in Stockholm, 10 December 2018.

3 Blomgren, A. et al (2015) "Industribyggerne 2015" . IRIS Report 2015/031 (Norwegian only).

4 World Bank "Ease of doing business index". data.worldbank.org/indicator/IC.BUS.EASE.XQ