Economic Survey

Perspectives

In many areas, developments in the Norwegian economy were favourable in 2004. Mainland GDP showed higher growth than can normally be expected. The moderate downturn that started in 2002 is now basically behind us. Prices for many important Norwegian export products rose markedly between 2003 and 2004, and in general far more than prices for Norway's imported goods and services. This resulted in terms-of-trade gains for Norway which, combined with GDP growth, led to an increase of 8 per cent in national disposable income in 2004. Comparable figures for GDP per capita show that Norway has one of the highest income levels in the world. The picture should, however, be adjusted because a substantial share of the value of petroleum production does not constitute income in the ordinary sense, but represents a tapping of natural resources. Norway saves a considerable share of current petroleum revenues. Preliminary estimates show that the current account surplus was close to 14 per cent of GDP in 2004, and gross investments in fixed assets came to 18 per cent of GDP.

Growth in the mainland economy picked up appreciably in 2004. The cyclical upturn has so far taken place in an environment of decelerating price and cost inflation in spite of higher commodity prices. Inflation, as measured by the consumer price index, was lower than it has been for many decades and far lower than the inflation target. Nominal interest rates have been very low from a historical perspective, while real interest rates were pushed up by low inflation. Employment growth has also been positive, but factors such as a sharp fall in sickness absence and increased use of overtime have contributed to only moderate growth in the number of employed. As a result, unemployment has not declined much in spite of the cyclical upturn.

The prospects for the Norwegian economy in the coming years are also favourable. Economic growth is expected to continue at about the same pace in 2005 as in 2004. The labour market is thus likely to improve and unemployment to fall. Low inflation will contribute to continued real wage growth, and household real income (adjusted for wide swings in dividend payments) will continue to rise. Petroleum investment, which for a generation has now played a decisive role in business cycle developments in Norway, is estimated to increase sharply this year and stay at a high level in coming years. This will contribute to retain the activity in parts of the industry. The price of petroleum appears to have moved up to a markedly higher level than most observers previously anticipated, which means that financial investment in Norway will remain at record-high levels. Many traditional export industries are also experiencing solid profitability.

The question may be raised as to whether the cyclical upturn in the Norwegian economy will gain momentum through 2005 to the extent that the economy enters into a boom period with overheating as we experienced both in the 1980s and in the latter half of the 1990s. There are several similar features: The labour market is growing tighter, petroleum investment is rising and economic policy is expansionary, particularly through low interest rates. Danger signals can be observed in for example high growth in household debt and a sharp rise in prices in some segments of the property market. In these areas, there is a risk that financial imbalances may arise.

Since the previous upturn, it should be noted that Norway has introduced policy rules that are to contribute to a stabilization policy that is better adapted to the cyclical situation than has been the case earlier. The fiscal rule is to ensure a gradual

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and sustainable phasing-in of petroleum revenues. At the same time, monetary policy has been given a clear role in stabilizing economic developments. Rules in themselves are not sufficient as a policy guideline, though, when the economy is exposed to shocks or when there is a substantial change in framework conditions. In response to weaker cyclical developments, interest rates were cut sharply through 2003, and the inflation outlook a few years ahead quickly changed from overshooting the inflation target to running below target. As regards fiscal policy, the question has been raised as to whether its implementation has in fact been in keeping with the fiscal rule. The use of petroleum revenues over the government budget is now clearly higher than the expected return on the Government Petroleum Fund. Over the past few years as a whole, fiscal policy has been moderately expansionary, and has thus contributed to stimulating the economy, rather than curbing the upturn. The upswing in the economy through 2004 did not, however, give rise to any serious pressure problems. The labour market has gradually improved, while wage growth has moderated. If the upturn continues at the same pace, it may prove necessary to put on the brakes. If, for example, high profitability in internationally exposed industries leads to stronger-than-anticipated wage growth and inflation, the central bank is likely to respond by increasing key interest rates. Perhaps this is where the main difference lies compared with the previous situation; monetary policy is to be used actively in stabilizing the economy. However, developments in 2002 show that there are limits to what the central bank can achieve. A marked interest rate increase in Norway in a situation where international interest rates remain low could again affect the exchange rate and competitiveness to the extent that the effects on the real economy would on balance be assessed as more negative than if inflation had been somewhat higher than target. In the current upswing, it is important to restrain fiscal policy so that it does not amplify these balance problems. The next few years may prove to be an important test of whether the different components of economic policy are pushing the economy in the same direction.

In addition to the question of fiscal policy in the short term there is the even greater challenge of long-term government funding requirements associated with the ageing of the population. The estimates presented by the Pension Commission and the Government's white paper on pension reform show that with today's social security system, government expenditure on pensions will more than double as a percentage of GDP in the period to 2050. The need for pension reform is thus highly justified. Alternatives are appreciable tax increases or cuts in other welfare schemes.

Such long-term projections are necessarily based on a number of uncertain assumptions, and it is entirely possible that developments in government finances will be more favourable than indicated in the government's analysis. The increase in life expectancy may, for example, be more moderate than implied by the recent population projections from Statistics Norway. It is also possible that the working age population will work more than earlier. Or one can hope that real crude oil prices remain high so that petroleum revenues can finance a larger share of pension spending.

However, it would not be sensible to take a chance on the prospect of a favourable outcome in all these areas. Funding requirements may just as easily prove to be higher rather than smaller. Alternative population projections show that the uncertainty here only applies to *how strong* the rise in the number of elderly will be. Furthermore, it is conceivable that a general rise in prosperity will induce the working age population to work less, not more than envisaged. Basing central welfare schemes on the assumption of high future oil prices is a very risky strategy. And even if the Petroleum Fund grows in size, there is no guarantee that the real return on the Fund will reach 4 per cent over time as assumed in the guidelines for fiscal policy. It can also be added that the long-term projections are based on very moderate estimates for growth in other expenditure such as on health and care services. Should spending growth in these areas prove to be more in line with historical trends, the public sector will be underfinanced to a larger extent than estimated.

In the light of the substantial uncertainty surrounding the room for manoeuvre in central government finances in the long term, it would be a considerable advantage for the pension system to contain mechanisms that strengthen growth capability and make growth in pension expenditure more robust to various outcomes. The proposal to modernise the social security system implies a clearer relationship between earned income and pensions than today's system. Moreover, it provides for a flexible retirement age with an associated adjustment of annual benefits. Both measures will stimulate labour force participation, and according to Statistics Norway's calculations such measures could have a considerable impact. In addition, the proposal includes measures to curb growth in benefits per pensioner, partly through a distribution of pensions based on life expectancy, which prevents pension expenditure from rising as a result of an increase in life expectancy.

The Government has followed up the Pension Commission's proposal to establish a pension fund with the Government Petroleum Fund and the National Insurance Fund as a basis. The new construction does not imply any substantive changes to the existing fiscal policy, but is aimed at strengthening the support for maintaining a high level of government saving in the coming years. Such a fund structure makes it easier to finance a given path for pension expenditure through high saving without placing an excessive burden on future taxpayers. But the funding itself does not contribute to reducing the overall dependency ratio inherent in the pension system. This can only be achieved through measures that increase the effective retirement age or that reduce benefits.

Even if petroleum revenues provide us with greater financial leeway and scope for maintaining a higher welfare level than would otherwise have been possible, petroleum wealth accounts for a relatively small share of total national wealth. Human capital, on the other hand, is clearly the largest component. In addition to maintaining a high level of labour force participation, a skilled labour force is of fundamental importance for wealth generation. Education policy is the most important tool for securing a highly qualified labour force. Quality is just as important as the number of years in education. Talented students must be given challenges and support, but it is equally important to help less talented students achieve a level of competence that enables them to become full-fledged members of tomorrow's working life. Recent findings and international comparisons show that the Norwegian education system is facing challenges in this area.

Technological and organizational innovation is often the result of research and development. Research results are disseminated internationally. Effective use of international research findings requires a high level of national research. In spite of considerable uncertainty surrounding the return on research, evidence suggests that a higher level of investment in research in Norway will increase the economy's ability to adapt and will provide an important growth impulse in the long term. In this area, however, it is also important not to focus primarily on quantity, but on the quality of research. The level of ambition and the pace of investment must, among other things, be adapted to the number of talented researchers.

The Norwegian economy has experienced remarkably favourable economic developments over several decades. Petroleum resources have been managed in a way that has become a model for other countries with an abundance of natural resources. But the favourable results of the past are no guarantee for continued progress. It is important to acknowledge that petroleum wealth and the return on this capital are modest in relation to the value added that is generated in the rest of the economy. It is the growth capacity in the entire economy that will be decisive for our country's prosperity over time. This should also be a guiding principle for the focus and priorities both at government level and in the business sector.