Economic Survey

Perspectives

2002 was a turbulent year for the Norwegian economy. The international downturn with falling interest rates, declining stock markets, fears of war and rising oil prices also influenced domestic developments. The value of the Petroleum Fund fell instead of growing, and the return was markedly lower than expected. Weakening profitability and activity in what was recently described as the new economy left a clear mark on the labour market. Continued high wage growth and a tight monetary stance contributed to a record-strong deterioration in competitiveness for the second consecutive year, with notices of relocation of production abroad and closures in internationally exposed industries. The international downturn and loss of markets shares for Norwegian enterprises led to a virtual halt in output growth in the Norwegian economy through 2002, following several years of low growth. This occurred in spite of brisk growth in domestic demand. In addition, the year ended with more negative news of low water reservoir levels and very high electricity prices. On the other hand, 2002 was a year with record-high growth in household real disposable income and inflation was kept at bay. A high and relatively equal distribution of wealth, continued low unemployment and solid national and public finances meant that last year was another year when Norway was among the countries that fared best.

2002 was also a year when economic policy was put to the test. Monetary policy has now been conducted using an official inflation target for two years, in practice since approximately 1999. Norges Bank sets its key rate with a view to achieving a rate of increase in the CPI, adjusted for tax changes and excluding energy products, of close to 2.5 per cent two years ahead. It was argued that an inflation target that is about a half percentage point higher than the monetary policy objective of our main trading partners was justified on the basis of a generally more expansionary fiscal policy in Norway as a result of the new fiscal rule on the phasing in of petroleum revenues into the Norwegian economy. The rule was introduced at the same time as the inflation target, and so far fiscal policy has been conducted closely in line with the rule. According to the rule, the central government will continue to save all current petroleum revenues, while the expected real return can be posted as income in the central government budget. In this way, the capital accumulated in the Petroleum Fund and remaining petroleum reserves will benefit all future generations. Furthermore, it is important to point out that this wealth will only be able to provide a moderate contribution to changes in consumption for present and future generations.

An expansionary fiscal policy stimulates demand for all types of goods and services. With high capacity utilization in the economy, increased demand for nontradable products can only be covered by a transfer of labour and other resources from the internationally exposed sector to the sheltered sector. Increased demand for internationally exposed products can be covered by an increase in net imports. Market forces ensure that resources are transferred from the internationally exposed to sheltered sectors via higher domestic price and cost inflation and/or an appreciation of the Norwegian krone against our trading partners' currencies. Such a real appreciation of the Norwegian krone leads to a weakening in competitiveness among enterprises that compete with foreign enterprises on export markets or on the domestic market. As part of the rationale behind the revision of the guidelines for economic policy in 2001, it was therefore assumed that an extra half percentage point inflation in Norway relative to our trading partners, with a corresponding weakening in competitiveness, would be necessary and sufficient to achieve structural changes as a result of the some-

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what more expansionary fiscal policy implied by the new guidelines. This implied that there would not be a need for a nominal appreciation of the krone.

A comparison of the assumptions and intentions underlying the policy revision in 2001with actual developments through 2001 and 2002 shows substantial deviations. A stronger krone resulted in a real appreciation that was markedly sharper than half a percentage point per year. The decline in manufacturing exports, output and employment over the last half of 2002 indicates that the weakening in competitiveness has started to have an impact. On the other hand, the krone weakened again at the beginning of 2003. It remains to be seen whether this is too little and too late to counter the shock to which many internationally exposed industries have been exposed. Forecasts point to a fairly substantial downscaling in the period ahead.

In recent years, movements in the krone have been difficult both to predict and explain, even in retrospect. One of the objectives underlying the introduction of an inflation target was that it would contribute to a stable krone exchange rate. There is broad agreement as to certain qualitative relationships, for example that a widening in the interest rate differential between Norway and other countries in isolation rapidly leads to an appreciation of the krone. But the quantitative strength of the effects and how rapidly they feed through to the domestic economy and competitiveness are difficult to predict with a large degree of accuracy. This implies that greater weight should be given to uncertainty in the formulation of macroeconomic policy and in particular monetary policy. The margin of manoeuvre in monetary policy seems to be more limited than previously assumed.

Irrespective of the reasons: There are grounds for considerable concern over the erosion of competitiveness in the internationally exposed sector in recent years. A lack of mobility in the labour market means that those who are made redundant in the manufacturing sector and other internationally exposed sectors become unemployed. Experience shows that unemployment to a large extent leads to permanent occupational passivity in the form of long-term unemployment, disability pensioners or early retirement. Moreover, even temporary swings in unemployment have both welfare and real economic costs. These costs must, however, be balanced against the risk of preserving an inefficient industry structure. The above arguments imply that monetary policy has long-term real economic consequences.

In the long run, however, the many and demanding wishes of consumers, voters and politicians, which require higher output and employment in the sheltered sector, should not make the challenge of achieving full employment a problem for Norway. The real challenge is to achieve full employment at the same time that a sufficient number of people work in profitable, internationally exposed enterprises. An important reason why economic policy should focus on full employment and activity in the internationally exposed sector at the same time is that sustainable economic growth must fulfil the requirement of long-term balance in the external account. This means that a country – like a family – cannot spend more than it earns in the long run. However, with Norway's expected current account surplus in the years ahead, this is not likely to give rise to any policy constraints. The fiscal rule for the phasing in of petroleum revenues into the Norwegian economy can be interpreted as an attempt to introduce such a constraint.

If it is not left to market forces alone to ensure that the Norwegian economy avoids imbalances in the external account, it follows that economic policy must give more weight to competitiveness and the distribution of resources between the sheltered and internationally exposed sectors. It is difficult to see that the fiscal rule implies over time an irresponsibly rapid phasing in of petroleum revenues into the Norwegian economy. In relation to the operational objective, monetary policy also seems to have fulfilled expectations. The monetary policy reform appears to have contributed to a more stable inflation rate than would otherwise have been the case, albeit at the expense of less stability in output and employment. On the other hand, securing stable competitive conditions for Norwegian enterprises has not been as successful.

Higher wage growth than the level consistent with the inflation target is weakening the position of the internationally exposed sector to a further extent than the assumption underlying the fiscal rule's long-term phasing in of petroleum revenues into the Norwegian economy. One problem with today's monetary policy is that it can amplify the erosion of competitiveness. The mechanism in brief is: Norges Bank will increase its key interest rate to counter inflationary impulses through lower demand and – not least – through the appreciation of the krone that may occur as a result of a widening in the interest rate differential against trading partners. While the appreciation of the krone curbs the rise in prices for imported goods and reduces the general rise in prices, earnings measured in Norwegian krone terms for internationally exposed enterprises weaken. Inflation targeting through higher interest rates has thereby amplified the weakening of competitiveness that was caused by high wage growth. In other words, one can expect a systematic negative relationship between the inflation target, inflation and the more fundamental objective relating to competitiveness in the internationally exposed business sector.

This effect of monetary policy is in clear conflict with the way we previously promoted the objective of competitiveness for Norwegian enterprises. Monetary policy was aimed at a stable krone exchange rate, and historically all the necessary available stabilization policy measures were used to secure competitiveness: Incomes policy, fiscal policy (expenditure, taxes and excise duties) if there was a need for additional measures, and even measures that no longer allowed the market to function (regulations and price and wage legislation). If the inflation target is to be an appropriate operational objective in a small, open economy like Norway, it must over time be as effective as or more effective than a direct exchange rate stability objective in securing competitiveness for the internationally exposed sector.

A fiscal policy that is primarily oriented towards a sustainable increase in the use of petroleum revenues in the Norwegian economy, combined with a monetary policy that makes such a phasing in possible through a somewhat higher inflation target than among our trading partners, seems to be well founded in theory. In practice, however, we have still not succeeded. In recent years, real wage growth and deteriorating competitiveness have clearly been incompatible with long-term balance in the Norwegian economy and a reasonable distribution of petroleum wealth across present and future generations. The later this is reversed, the higher the costs will be to put the economy back on the right track. At the same time, we are facing the many challenges posed to the short-term management of a small, open economy like Norway. Rising unemployment bears testimony to this. To some extent, this is a question of two sides of the same coin. One of the main problems seems to lie in the linkage between the inflation target, the interest rate as an instrument and the effects on the krone, and the use of fiscal policy in cyclical policy.

If competitiveness is assigned fundamental importance, as assumed in both the long-term management of petroleum wealth and short-term cyclical management, today's monetary policy has considerable limitations. The margin of manoeuvre for an independent Norwegian interest rate policy has in practice proved to be narrower than most had expected, which the recent interest rate reductions would also indicate. However, continued weight on competitiveness and short-term economic stability as a priority objective would then place greater demand on fiscal and incomes policy. It is easy to increase public expenditure and show wage moderation during a downturn. The ability and willingness to tighten fiscal policy and refrain from using bargaining power during an upturn have, however, so far not been quite as prominent. But this will be a necessary price to pay if competitiveness, the long-term management of petroleum wealth, high employment and low unemployment are to be given equal weight.