Economic survey

Perspectives

2001 was the third year in which the Norwegian mainland economy recorded a growth pause. In the course of last year, the labour market showed some deterioration while underlying price inflation gradually slowed, partly as a result of a substantially stronger krone exchange rate. 2001 was a favourable year for most people due to growth in real income and high employment. A high oil price over the past two years has resulted in record current account surpluses, and petroleum revenues have been manifested in a rapidly rising Government Petroleum Fund. This, combined with high cost inflation and increasing pressures on the public sector, led to important economic policy choices. 2001 was the year in which we decided to move forward – not backward into an oil-driven economy.

In 2001, the authorities introduced two new guidelines for economic policy. Monetary policy shall hereafter be oriented with a view to achieving a moderate rise in consumer prices compared with the earlier objective of maintaining a stable exchange rate against the euro. In fiscal policy, the expected real return on the Petroleum Fund is to be included on the revenue side of the government budget, with petroleum revenues being gradually phased into the Norwegian economy. In practice, this means that fiscal policy will be somewhat more expansionary than planned earlier. The new guidelines imply that the central government will continue to save all current petroleum revenues in the Petroleum Fund. In this way both the Petroleum Fund and the remaining value of petroleum reserves will benefit future generations.

The authorities' decision concerning how much of the total petroleum wealth shall finance current consumption has a considerable influence on Norway's total saving and hence consumption possibilities in the future. Even though it is not derived in a stringent way from first principles, the fiscal policy guideline has many intuitive advantages:

- It satisfies a need for predictability in the question of when petroleum revenues are to be used. This need has risen as the petroleum wealth more liquid and hence more visible.
- It is relatively simple to present and implement in practice.
- The current policy guidelines were introduced at a time when the fiscal policy stimulus, measured by the structural and activity connected state budget deficit, was very similar to the new guidelines, with the result that the transition itself did not create problems for the Norwegian economy. The guideline entails a gradual phasing in of substantial financial revenues through the Petroleum Fund.
- The guideline separates the use of revenues from cyclical fluctuations in current petroleum earnings. This means that, in contrast to what Norway has experienced earlier, we can avoid abrupt and substantial adjustments in fiscal policy for budget balance reasons.
- The guideline implies that a large portion of the petroleum wealth shall continue to be saved. The accumulation of financial assets means that we can limit reductions in tax-financed public services and/or growth-inhibiting tax increases when the ageing of the population increases public expenditure on pensions.
- The guideline applies to the management of a large portion of central government wealth in general, irrespective of the size of current petroleum revenues. When all petroleum reserves have been depleted and the Petroleum Fund has

reached its maximum size, the guideline can still be applied in the same way as in 2002. In this respect, the guideline is not confined to any one situation or time.

- Because the policy has been set out as a guideline, this places constraints on fiscal policy, making it more difficult to allow short-term considerations to dominate in a situation when the budget balance itself does not impose particular constraints on policy.

An important objective of economic policy ever since the dramatic fall in oil prices in the winter of 1985/1986 has been to reduce the Norwegian economy's sensitivity to rapid shifts in petroleum revenues. Following a turbulent adjustment period, recent years have generally been characterized by high petroleum revenues and a strong expansion of the Norwegian economy. This has permitted a high level of central government saving accompanied by a sharp growth in interest income from the Petroleum Fund and increased scope for manoeuvre in fiscal policy. However, we need to look no further than 1998 to find a year when a sharp drop in oil prices resulted in a tightening of economic policy that was perceived as fairly painful. As a result of the caution exercised, we are now in a position to combine substantial economic policy leeway with a gradual phasing in of petroleum revenues into the economy. The historical experience of Norway's oil policy, as well as that of other countries' experience of financial imbalances, clearly demonstrates how high the costs can be if a substantial tightening of policy over several years proves necessary.

Long-term projections of the Norwegian economy show that the sharp rise in the number of elderly persons from around 2020 will result in considerable increases in general government expenditure on pensions and health care. The new fiscal policy guideline will contribute to financing this spending growth, thereby allowing us to avoid substantial cutbacks in public welfare services and large increases in taxes for the economically active population in the future. Even with the new guideline, however, adjustments of taxes or the social security system will be necessary in order to maintain a reasonable budget balance when we face the challenges of an ageing population. These adjustments should be acceptable when we take into account that the expected number of years as a pensioner will increase in pace with a projected rise in life expectancy. No pension system, whether this be private pension saving or a public social security scheme, will survive financially without higher contributions if the number of years of disbursement increase. Assessed in the light of such fundamentals as the supply of economic resources and age composition, all of our neighbouring countries and trading partners will be in an even more demanding situation. It is particularly the maturing of the system for supplementary pensions that is generating substantial pressures on public finances in Norway compared with other countries where reforms will contribute to curbing growth in public expenditure.

Even though the new fiscal policy guideline has many sound features, it remains to be seen whether they will be observed. Adherence to the guideline will result in the accumulation of very substantial capital in the Petroleum Fund. This Fund will be very liquid and visible compared with oil and gas under the seabed. The question is whether voters and politicians will manage to maintain discipline as required by the guideline when pressures for more public-financed services and transfers gradually increase.

An important precondition for encouraging saving is to define clearly the benefits we can look forward to. Here, the policy seems to lack sufficient clarity. The ageing of the population is obviously a clear motive, but it is in no way self-evident that the future care of the elderly and pensions should take precedence over other benefits when deciding how the return on the Petroleum Fund is to be used. On the other hand, it is difficult to envisage a clearer saving objective for which there would be consensus. The freedom inherent in not defining a saving objective may be costly. The result may be that the guideline is quickly breached and that the wealth is saved to a far lesser extent. The lack of clarity as to how the revenues are to be used may also reinforce the impression that the wealth is "in play". We run the risk that considerable resources are used in a contest where the objective is to obtain a share of the petroleum revenues before it is too late.

Norway has become one of the richest countries in the world. Our natural resources have made a definite contribution, but this also applies when GDP is adjusted for the resource rent in the petroleum sector. However, not many countries with similar access to substantial natural resources have succeeded in exploiting this advantage in an equally sound manner. A contest for natural resource revenues has been suggested by many observers as a plausible explanation as to why countries that have experienced a windfall eventually end up among the less prosperous countries. Another explanation is that these countries have had a myopic view of the wealth acquired. A rapid use of the wealth can create habits and attitudes in relation to consumption and work that are very difficult to reverse. In practice, it has proved to be far more difficult to reduce real income than to increase it, which is a pleasant process. The guideline for the use of the real return on the Petroleum Fund will help to ensure that the benefits of a "natural windfall" will be lasting and not result in the displacement of other income, so that we do not end up squandering our natural advantages.

It is absolutely not the case that the real return on the Fund will gradually be of such a size that there will no longer be a need for an internationally exposed sector in Norway. Petroleum revenues, both now and in the future, will only be able to cover a small portion of our need for internationally mobile goods and services. Nor will our other natural resource-based industries be able to bridge this gap. This means that as we gradually increase the use of petroleum revenues in the economy, we must also further develop the type of industry that is virtually free to choose its country of location, i.e. companies that are not dependent on geographical proximity to Norwegian natural resources or Norwegian customers. If this rootless type of enterprise is to be located in Norway, it must be profitable under the conditions that prevail here. However, there is no validity in the view that the level of wages required by internationally exposed industries is clear-cut. In reality, these rootless enterprises, both those in existence and those in the future, are a heterogeneous group where the ability to remunerate labour and other input factors varies considerably. However, this does not imply less stringent requirements concerning prices and costs, requirements that will be particularly demanding to satisfy in a situation when it is easy to become exuberant as a result of rapidly rising financial wealth abroad.

It is important that cost requirements do not result in attempts through various business and tax policy instruments to secure sufficiently favourable operating parameters and hence the competitiveness of internationally exposed enterprises. This would not solve any problems if wage formation does not function in a way that is compatible with the capacity to pay wages in a sufficiently large internationally exposed business sector. Various types of support would then be quickly passed on to wages. The problem with international competitiveness would then not only remain nonsolved. In addition, the economy's ability to derive welfare from its resources will have deteriorated over time. Selective support schemes create distortions and entail an inefficient use of resources and less clear-cut operating parameters. Moreover, support schemes must be financed and this also contributes to inefficiency. The prospect of favourable operating parameters increases the profitability of using resources for lobbying instead of production. Increasing the profitability of the business sector through transfers and other support is an effective but not particularly forward-looking way of using petroleum revenues.