LSE European Institute "Perspectives on Europe" public lecture

How to boost growth as the oil price falls – Transformation and reform of the Norwegian economy

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Friday 11 March 2016

Link to online transcript:

https://www.regjeringen.no/en/aktuelt/how-to-boost-growth-as-the-oil-price-falls--transformation-and-reform-of-the-norwegian-economy/id2479604/

"The most important international market for us is clearly the European market. Ever since it took effect in 1994, the Agreement on the European Economic Area – the EEA – has been the cornerstone of our Europe policy" the Finance Minister said in her Speech at London School of Economics.

Check against delivery

Ladies and gentlemen,

It is a great pleasure to be here at the London School of Economics and Political Science. The LSE has contributed substantially to economic and political science throughout the years, and has helped to shape our views on economics and indeed on economic policy. This school has educated many excellent economists, political scientists and law specialists, and I am pleased to say that some of them are serving at my ministry in Oslo.

The economic theory developed here and in other prominent universities helps us understand how markets work and how economic agents interact, and lays the foundation for modern government. As policy makers, however, we are not only concerned with understanding how the economy works, but even more importantly, how it *should* work: How can we design economic mechanisms and institutions that support our objectives more effectively? How can we design

government in a way that makes the economy more robust against disturbances and promotes productivity and economic growth?

Many LSE academics have made substantial contribution to normative economics and several have been awarded the Nobel Prize in their field:

- **Leonid Hurwicz** used game theory to prescribe the design of optimal mechanisms – how markets should be organised.
- **Robert Mundell** gave new insight in how targets and responsibilities should be organised between the government and the central bank.
- And **Friedrich Hayek** studied how economic systems should be set up – or not set up. To name a few.

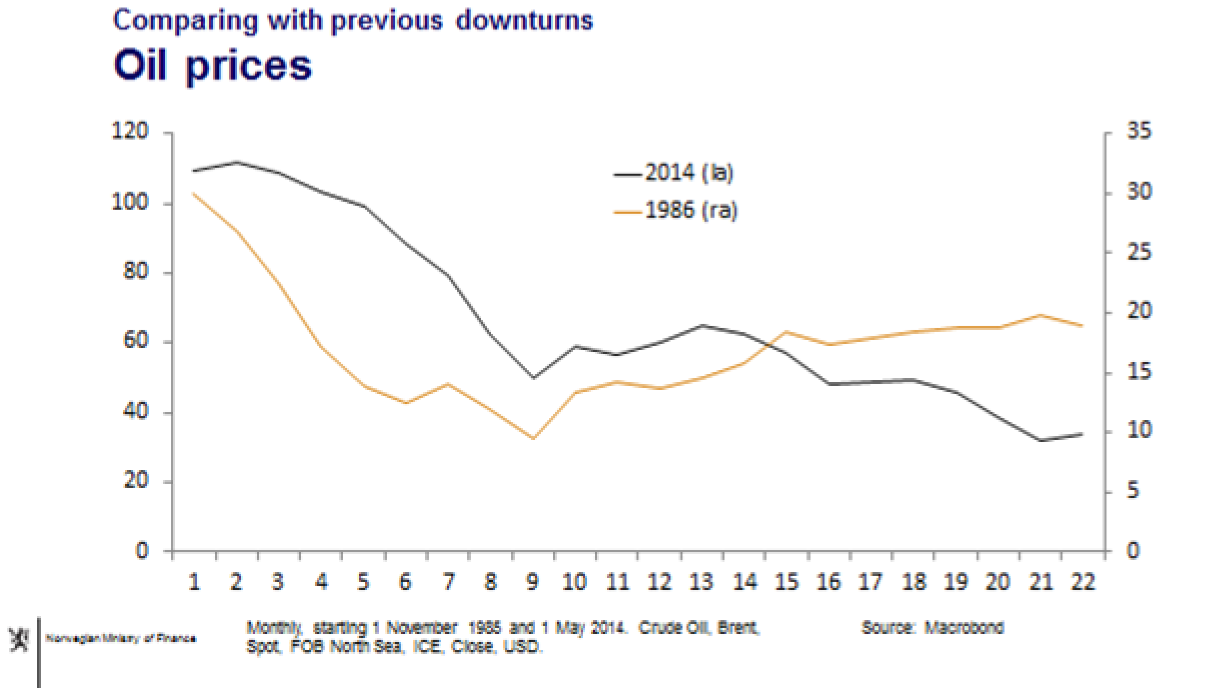
What they had in common, was their quest for using fundamental economic theory to design economic policy that provides good outcomes. Objectives are often easier to achieve when decisions are left to economic agents facing the right incentives, rather than to an all-mighty political planner. I imagine some of these scholars would rather claim that fine-tuning the economy by politicians in many cases rather increases the problem.

I will use this lecture to reflect upon how to design a good macro-economic stabilisation framework based on recent experience of the Norwegian economy. Assigning the right objectives to the right institutions is crucial to developing a sound and robust economic and financial system. I will also touch upon the importance of international co-operation, where large countries need to manage their responsibility as leaders in the international marketplace.

A robust framework for economic policy

Policy makers are elected to pursue different political objectives. Often, political objectives are linked to fiscal policy, either through specific priorities for government spending or priorities related to the level of different taxes. The finance minister is obliged to strike a balance between all the political ambitions and a sustainable fiscal policy. Striking that balance can be demanding, especially since uncertainty and shocks to the economy continuously influence our ability to pursue our goals. Robustness against unforeseen shocks should be an important criterion when assigning the division of roles between fiscal policy, monetary policy and the social partners.

Figure 1 Comparing oil prices



For a long time a fixed exchange rate was the order of the day, not only in Norway but also in the UK. The fixed exchange rate regime was a design that put heavy burdens not only on fiscal policy, but also on the social partners. In economic downturns, fiscal policy needed to *contract* to support the currency peg, and adjustment in the real exchange rate was left to the social partners through – often painful – adjustments in the wage level.

Ever since I was first elected to the Norwegian Parliament some 20 years ago, I have believed that economic policy would benefit from delegating an inflation target for monetary policy to the central bank. The UK adjusted its macroeconomic framework in the late 1990s, providing a clearer division of roles and responsibilities between the Treasury and the Bank of England. Norway followed in 2001 - an inflation target was introduced in parallel with a spending rule for fiscal policy.

From a finance minister's viewpoint, it's a bit of a paradox that we can achieve more by relinquishing the opportunity to decide the interest rate ourselves. I believe the paradox was first pointed out by the economist Finn Kydland (a Norwegian) and Edward Prescott, for which they were later awarded the Nobel prize.

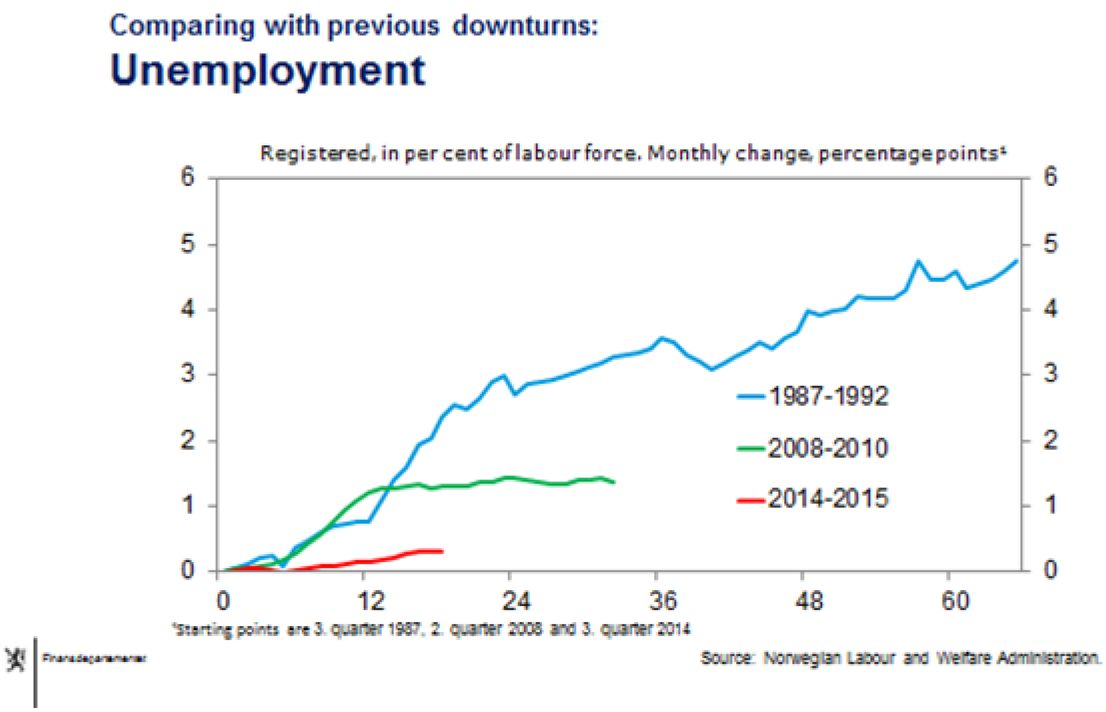
By introducing inflation targeting, a new division of roles was introduced to the economic policy framework. Monetary policy is responsible for nominal stability and can also contribute to stabilising the real economy in the short run. The central government budget – growth in public expenditure – has a longer-term focus and influences the balance between the public sector and

the private sector. The budget will be used to decide on the size and the scope of the welfare state, which by nature should not fluctuate from year to year. Wage formation and economic structures and incentives lay the basis for the effective and efficient use of labour and other real economic resources, and for economic growth.

The objectives that we assign to fiscal policy and to monetary policy must harmonize with what the different policy instruments have the ability to achieve. That is the crucial lesson in designing a good macro-economic policy framework.

The division of roles has been put to a test recently. As you know, oil and gas prices have fallen markedly since the summer of 2014. Being one of the world's large petroleum exporters, this constitutes a major negative shock to the Norwegian economy. The previous time we were exposed to a shock of the same magnitude was in the late 1980s. A comparison of economic developments then and now is useful. In size, the two oil price shocks are similar. Economic developments, however, differ substantially.

Figure 2 Comparing unemployment rates

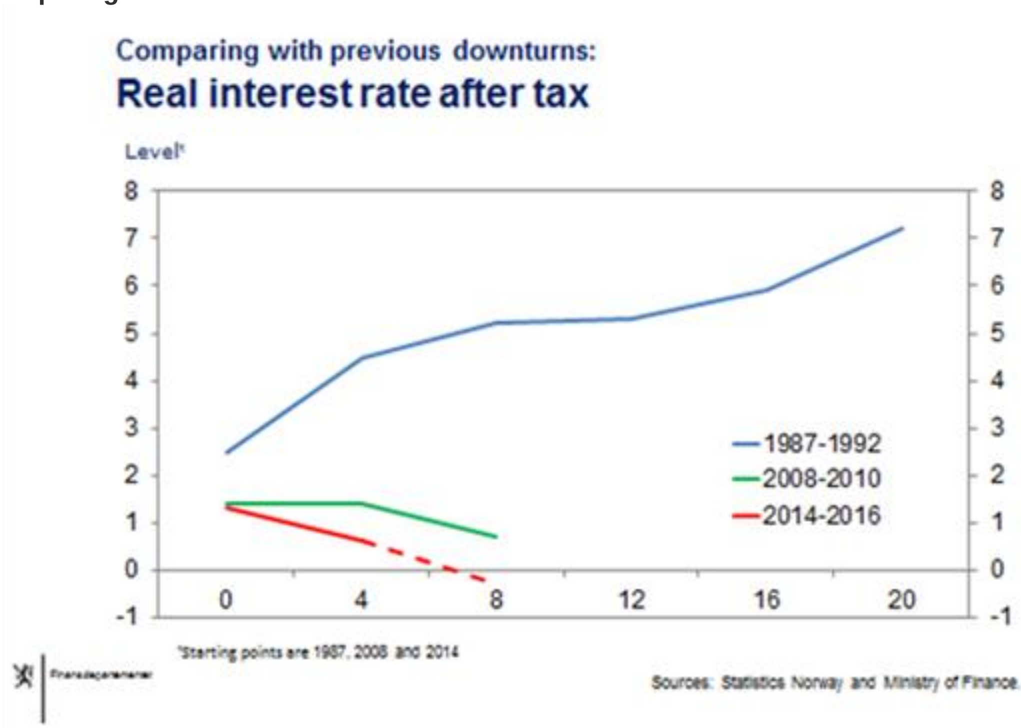


The oil price fall in 1986 ushered in a long period of economic turbulence, with a sharp and a lingering increase in unemployment. This time, the increase in unemployment has been more subdued. And, importantly, this time employment has continued to increase, in contrast to the sharp fall in the late 1980s.

I believe that one reason our economy is so far coping fairly well despite the 70 per cent drop in oil prices is the macroeconomic cushions that we have established. Three components of our economic policy framework have proved particularly important:

First, monetary policy is aimed at low and stable inflation with a floating currency.

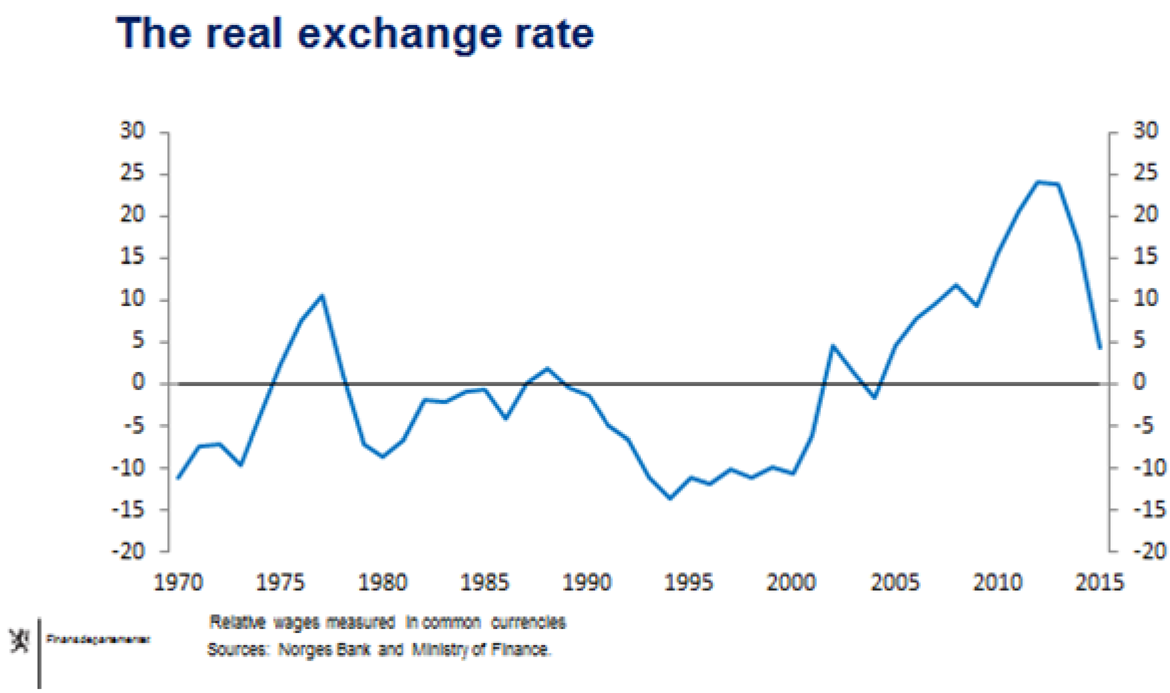
Figure 3 Comparing real interest rates



The central bank no longer sets the interest rate with the purpose of stabilising the currency, but with the view to safeguard low and stable inflation. That will also typically contribute to a counter-cyclical monetary policy. In good times, with prospects for increasing inflation, interest rates are increased. And in economic slowdowns, with prospects for weak growth and low inflation, interest rates are reduced. Monetary policy acts as an important cushion in economic policy. Instead of leaving the stabilisation task to fiscal policy it has become our first line of defence in economic stabilisation.

Earlier, when a stable currency was deemed top priority, setting the interest rate was done under constraints that often amplified the fluctuations in the economy. That was clearly the case in the late 1980s, when the real interest rate increased sharply (the blue line in the figure).

Figure 4 The real exchange rate



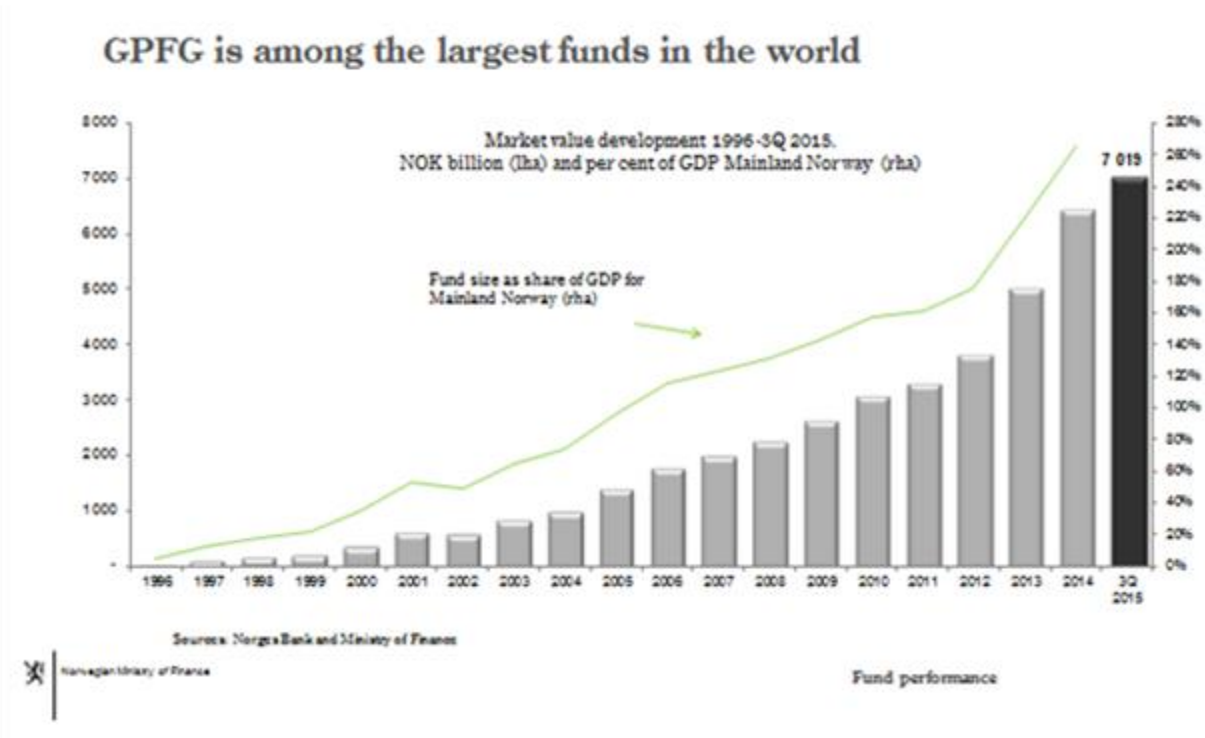
The floating exchange rate has been virtuous this time. The booming years from the beginning of the millennium came with a relatively strong real appreciation and increasingly high cost level, as one would expect. Now, we have to reverse that development. In the current international environment of low real wage growth, it would have been quite an ordeal to improve our competitiveness through wages alone, as was the case under the fixed exchange rate regime. With a floating currency, a real depreciation could take place through the nominal exchange rate. Our currency has depreciated by 15-20 per cent against our main trading partners over the past couple of years.

Such a large and swift adjustment in the competitiveness is key to stabilising the economy after the decline in the petroleum sector and to support the transition of labour to new competitive sectors. It may, however, take some time before we see the full impact on domestic activity.

Second, we have strong public finances and a prudent, but flexible fiscal framework.

The fiscal guideline that was introduced in 2001 implied saving a large part of the increasing petroleum revenues in a fund. The fund today amounts to more than 800 billion US dollars or close to 3 times non-oil GDP (figure 5).

Figure 5 Norway's sovereign wealth fund is among the largest funds in the world



Our fiscal policy framework is based on prudence and the distribution of the oil wealth between generations. All the governments' petroleum income enters the fund, while only the expected real return on the fund is spent over the budget. As a consequence, we are not spending oil revenues as such, but the financial return on the fund. As opposed to many other countries that experience economic distress, our solid public finances allow automatic stabilisers to work. In short, we do not need to cut welfare when facing a cyclical income shortfall. On the contrary, we are in the position to conduct counter-cyclical fiscal policy, without the imminent constraint of excess debt burdens, as many other countries experienced after the financial crisis.

Fiscal strength is certainly a short-term advantage in that it can help us smooth the transitional phase of increased idle capacity. At the same time we believe that expanding the public sector is not the right answer when the challenge by nature is structural. The economy must adapt to a *new normal*, where the petroleum industry is a less prominent growth engine than it has been over the past 10 to 15 years.

The third important buffer I would highlight is a robust and well-functioning financial sector.

In the late 1980s, the combination of high interest rates, high inflation, high marginal taxes and tax deductible interest payments, bad banking and a heavily indebted household sector eventually led to the Norwegian banking crisis, which had severe consequences for our

economy. The financial industry is vital both to economic stability and growth. Whereas a fragile financial sector tends to amplify an economic crisis, a solid, well-capitalised one may even be able to cushion a downturn.

We need strong regulation and supervision to ensure that our banks are robust and our capital markets are efficient. The international financial crisis has shown the need for good financial market regulation and supervision both nationally and internationally. Norway is a strong supporter of the current efforts to improve regulation and supervision of banks and other financial institutions, and the development of consistent regulation securing that the same risk is regulated in the same way in all financial institutions.

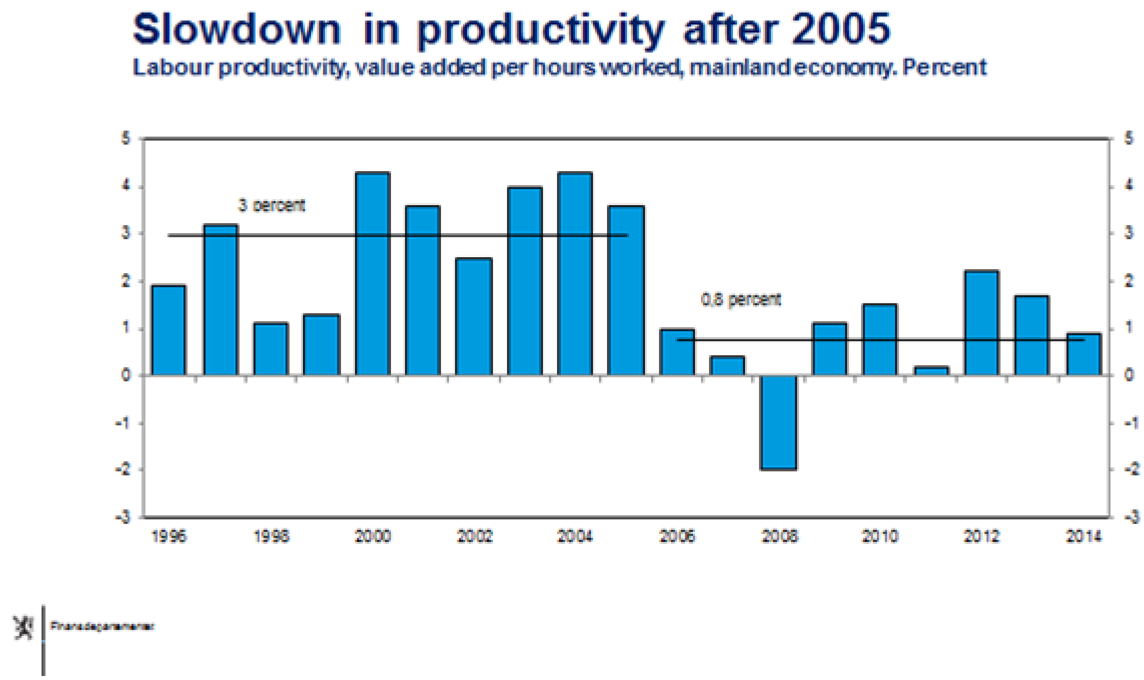
The Norwegian authorities have also acted early to phase in the different versions of the Basel and EU banking regulations, and are often a bit stricter than the minimums requirements under these frameworks. Over the past years, more solid banks have been a priority, and the banks have to a large extent used their profits to expand their capital base. Today, thanks to the increased capital requirements, our banks can enjoy a solid position in the funding market and appear less risky to investors.

For Norwegian banks as a whole, the leverage ratio, measured as the core equity capital relative to the total balance sheet, stood at an average of 7.5 per cent at year-end 2015. This is far above the minimum requirement in the Basel framework [3 per cent] and indeed very high in a Nordic and European context.

An ambitious reform agenda

As most advanced economies, we have seen a significant fall in productivity growth in recent years. Trend growth in productivity in Norway is now historically low, at below 1 per cent, compared with an average of about 3 per cent in the previous period. This is an international phenomenon. Norway fares better than many other countries, but this tendency needs to be turned around. We also have to deal with an ageing population and an underutilisation of labour. The welfare of our citizens and the sustainability of our public finances in the longer term depend on how we handle these issues.

Figure 6 Slowdown in productivity growth after 2005



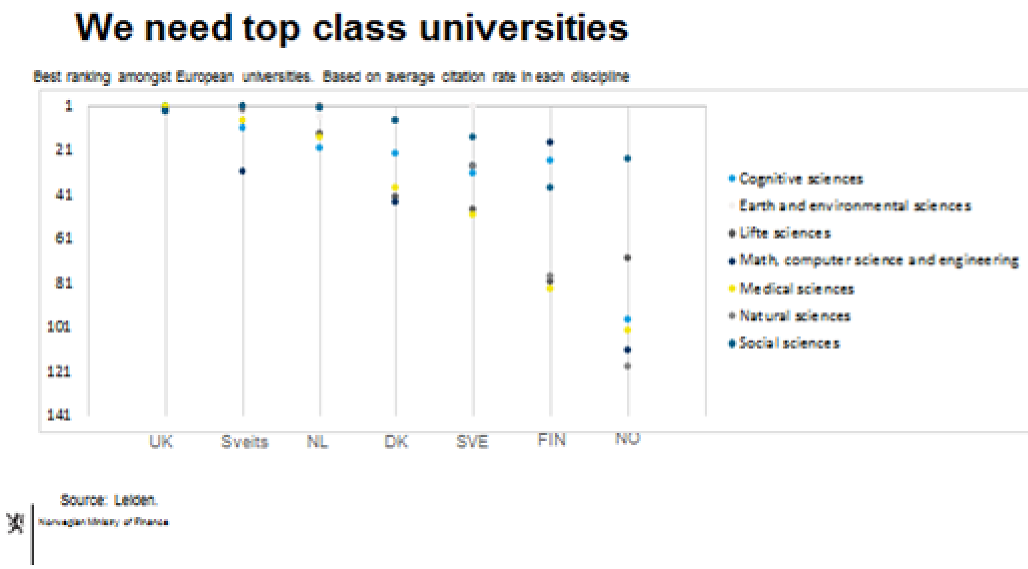
The crucial point is productivity growth. To quote another associate of LSE, Paul Krugman: “Productivity isn’t everything, but in the long run it is almost everything.”

Therefore, the Norwegian government appointed a Productivity Commission with a mandate to identify and analyse the causes of the slowdown and to give advice on reforms to increase productivity growth.

The Commission has highlighted several sectors with low productivity growth, among them the food processing industry and several service industries. The lack of international competition was pointed out as one of the main reasons for low productivity growth in these sectors. Another sector with low productivity growth has been the construction sector. The large inflow of immigrant workers, many from Eastern Europe, has been important for overall growth in the Norwegian economy, but less so for productivity.

The Commission highlights higher education, research and innovation, a well-functioning labour market and efficiency in the public sector as areas where reforms could bring large potential gains.

Figure 7 Few Norwegian top universities



Having top class universities, such as the London School of Economics, is important both to attract the best students and the best scholars. As this chart shows, we are lagging behind not only the UK and Switzerland, but also our Scandinavian neighbours in this respect. The Productivity Commission points out that increased emphasis on quality in higher education is essential to transform our economy into a more knowledge-based economy.

To support economic growth the government has set up an ambitious reform agenda. We have already embarked on several reforms in order to ensure that working, saving and investing pays off.

Figure 8 Important reform initiatives

We are reducing the overall tax level, for both households and businesses, and improving the design of the tax system to stimulate more environmentally friendly behaviour.

We are implementing reforms to make the public sector more efficient.

Our public sector is large, occupying about 30 per cent of the labour force. Benchmarking of institutions indicates a large potential for efficiency gains.

A reform of the transport sector is under implementation with the aim to enhance efficiency and economic profitability through reorganisation and more competition in this sector. We have reorganised the railway sector to achieve a more market-oriented and efficient governance structure, and established a new road development company in order to develop our big highway projects more efficiently and at a lower cost.

I believe in a free and independent business sector without special treatment or anti-competitive agreements, a free flow of goods and services and free access to markets. These are prerequisites for strong productivity growth. Therefore, we should foster competition and trade, both domestically and across borders, we should remove structural impediments and barriers to entry.

For a small country like Norway, adaptation of international technology is crucial. Openness, in the form of trade, foreign ownership and human mobility facilitates such adaptation. Competition provides incentives to engage in innovation and technology adaption. Competition also

contributes to reallocation gains, as low-productivity businesses are closed down and replaced by higher-productivity businesses.

The government aims at a flexible labour market where workers possess skills demanded by employers. Active labour market policies and flexible employment protection has been central to Norway's ability to facilitate structural change in the economy and reallocation of labour.

The importance of international co-operation

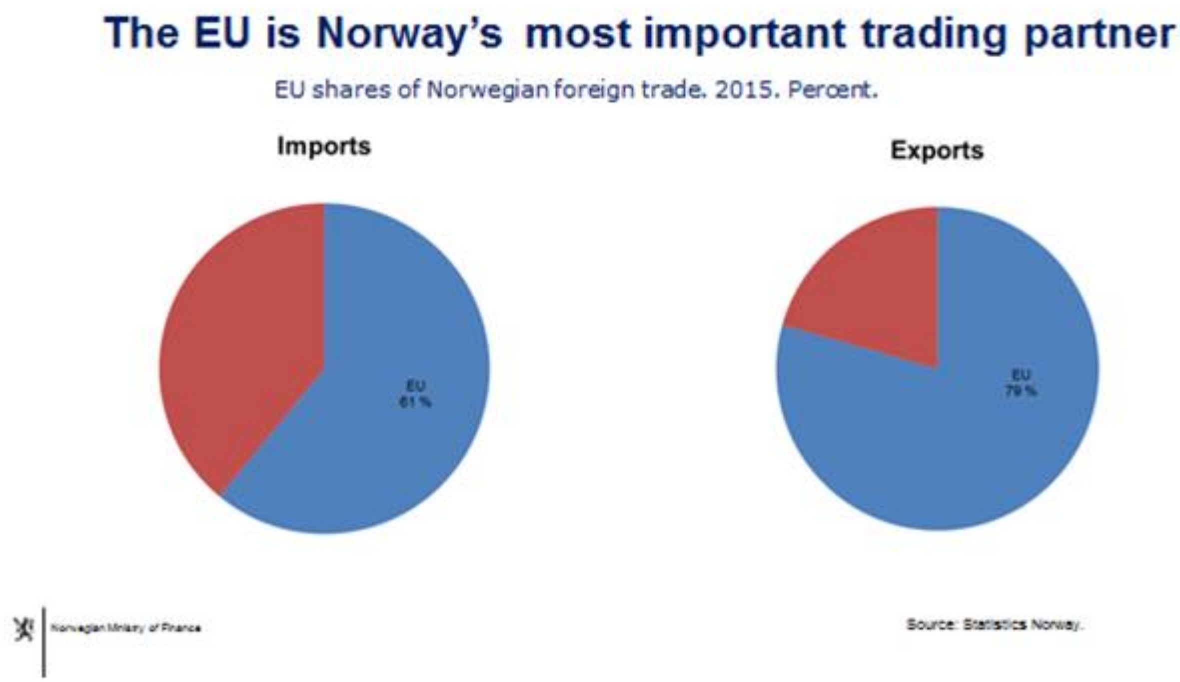
I have underlined the importance of open and well-functioning markets. Few other countries have made such a large bet on the capitalist system as Norway. Our natural resources have value only as long as we can export to the international market, and we invest our sovereign wealth fund in stocks, bonds and real estate all across the world. Access to foreign markets is of utmost importance. Good and stable framework conditions internationally are essential. Therefore, we are staunch supporters of global institutions that foster trade and free investment like the IMF and the WTO.

The most important international market for us is clearly the European market. Ever since it took effect in 1994, the Agreement on the European Economic Area – the EEA – has been the cornerstone of our Europe policy. The EEA brings together the 28 EU member states and Norway, Iceland and Liechtenstein in an internal market governed by the same basic rules. The Agreement provides for participation in the internal market for all sectors except agriculture and fisheries, and ensures that our households and businesses enjoy the same benefits as their EU peers in the European market. It provides predictability and a level playing field.

Under the EEA Agreement, Norway has become closely linked to the European integration process. The agreement is dynamic, meaning that new EU regulations are taken into the EEA Agreement. The cooperation has also extended to more and more areas. We take part in the Schengen agreement and cooperate closely with the EU on foreign policy and security issues. We participate in preparatory work under the Commission. As a non- EU member, we obviously do not take part in the decision-making process within the EU, but there is a small space for adaptations when the regulations are taken into the EEA. There is also a possibility to veto new regulations, but that has almost never been used.

Figure 9 illustrates the importance of the EU countries for the Norwegian economy. One could almost claim that we are economically more integrated into the EU than some euro area countries.

Figure 9 The EU is Norway's most important trading partner



The free movement of persons within the EEA has generally served Norway well. In the booming years, inflows of labour mitigated overheating and restrained the rise in the cost level. Labour migration has in fact been a stabilising factor in the Nordic countries since the 1950s, when the common Nordic labour market was created. After the EU expansion eastward, Norway has been one of the countries receiving the largest number of labour migrants from Eastern Europe per capita.

Like in Britain, the export of social benefits has become an issue in recent years. We support the British calls for some kind of threshold for when benefits may be claimed or cost level indexation of exported benefits.

From an economic point of view, I believe the most valuable part of European cooperation is the internal market. Still, there is room for improvement: Regulations need to be better and lighter, barriers to cross-border trade and investment need to be reduced further, and there is a substantial amount of red tape in the system that needs to be cut.

New business models create new challenges, which need to be tackled. A topical trend is the sharing economy, or perhaps more precisely, the web-based economy. The web knows no borders. Therefore, we need international cooperation to help regulate and tax these new businesses correctly. The EU is right to take a lead here.

Closing

When the London School of Economics was established 121 years ago the vision was to share knowledge and to shape a better world. Today, the school's mission is to advance knowledge in social sciences so as to inform public policy and economic decision-making "for the betterment of society".

That goal is important. That goal is ambitious. And the outcome of that goal is useful. I have described how we have benefitted from economic theory and research when designing our policy framework in Norway. The LSE has been an important provider of such knowledge.

The school' strategy states that it will **continue** to nurture creative thoughts and intellectual exploration to educate critical thinkers and skilled professionals around the world. I will encourage you to vigorously pursue that strategy. I hope our lessons from Norway illustrate that your mission is indeed pertinent. How to improve productivity and economic growth is still one of the major quests for policy makers and for economic theory. Hopefully, we shall continue to develop our understanding of the economy – policy makers and universities together.

Thank you.