Ministry of Finance

Report no. 29 to the Storting

(2000-2001)

Guidelines for economic policy

Recommendation by the Ministry of Finance of 29 March 2001,

approved by the Council of State the same day.

1 INTRODUCTION

The Government's primary economic policy objectives are high employment, an equitable distribution, the further development of the Norwegian welfare society and sustainable development. The Government will continue to pursue an economic policy based on the Solidarity Alternative, which was the result of the work of the Employment Commission. The implementation of the Solidarity Alternative has yielded beneficial results, with higher employment and lower unemployment. Fiscal policy must contribute to stable developments in output and employment. The Government places emphasis on continuing incomes policy cooperation, where the social partners through moderate wage settlements shall contribute to maintaining a strong internationally exposed sector. Monetary policy shall underpin fiscal policy and incomes policy to ensure economic stability. Low inflation and stable developments in output and employment are preconditions for a stable exchange rate. The continuation of these key elements of the Solidarity Alternative will contribute to securing full employment and a strong internationally exposed sector. The various components of economic policy must be complementary in order to achieve these objectives.

The Norwegian economy has been expanding at a rapid pace in recent years, with limited available spare capacity. At the same time, fiscal policy is faced with demanding challenges associated with the projected strong increase in spending on pensions and health care at the same time as petroleum revenues start to decline. Both short-term and long-term considerations have thus made it necessary to maintain a tight fiscal stance.

Petroleum revenues have been substantially higher over the past two years than assumed earlier. This has resulted in large transfers to the Government Petroleum Fund, and increased the scope for using the return on the capital in the Fund. The Petroleum Fund is expected to continue to show substantial growth also in the years ahead. This has increased the scope for manoeuvre in fiscal policy. The Government is of the view that against this background there is a need for a clear, long-term strategy for the use of petroleum revenues (cf. Chapter 2).

Furthermore, the Government is of the view that there is a need for a clearer anchoring of monetary policy's role in underpinning economic stability. Against this background, the guidelines for monetary policy have been revised today, with the adoption of a new regulation on monetary policy (cf. Chapter 3).

The new monetary policy guidelines, combined with the new guidelines for fiscal policy that are now being drawn up, will provide a sound basis for continued stability in the exchange rate, low inflation and stable developments in output and employment.

2 FISCAL POLICY GUIDELINES

2.1 Main features of economic policy

In line with the Government's Long-Term Programme for 2002-2005 (Report no. 30 to the Storting for 2000-2001), economic policy shall safeguard the following main considerations:

- Economic policy must contribute to *economic stability*, avoiding pronounced cyclical fluctuations. The Fiscal Budget accounts for such a substantial share of the overall economy in Norway that in practice it is impossible to achieve economic stability without fiscal policy assuming a main responsibility. Monetary policy can partially ease the burden on fiscal policy in stabilising the economy. However, caution must be exercised in placing an excessive burden on monetary policy. Incomes policy cooperation must contribute to keeping cost inflation in line with that of our trading partners to secure a sustainable basis for low unemployment.
- Economic policy must be *sustainable over time* to avoid the need for extensive policy shifts that weaken the basis for public services. Government budgets are expected to show substantial surpluses over the next ten years, with sizeable transfers to the Government Petroleum Fund. However, over time petroleum revenues will decline while expenditure on pensions and health care will increase sharply. In order to address these challenges without substantial fiscal tightening in the future, a large share of the high petroleum revenues must be transferred to the Government Petroleum Fund over the next ten years.
- Economic policy must contribute to the *efficient use of resources* both in the public and private sector. The room for manoeuvre in fiscal policy is not determined primarily by the available petroleum revenues, but by the size and skills of the labour force and the level of resource efficiency. Over time, a strengthening of the work approach in employment and social security policy, the work on enhancing and renewing the public sector, and other measures to improve the functioning of the economy are crucial to securing and

developing our welfare arrangements. The formulation of fiscal policy must also support the efficient functioning of the economy.

2.2 The long-term room for manoeuvre in fiscal policy

The Norwegian economy has expanded at a rapid pace since 1993. The sharp economic upswing led to a situation with limited available capacity. Fiscal policy was tightened in order to counter rising price and cost inflation. At the same time, fiscal policy faces long-term challenges as expenditure on pensions and health care will rise sharply as petroleum revenues start to decline. Against this background, fiscal policy must take into account both cyclical developments and long-term developments.

High oil prices have yielded substantially higher government petroleum revenues than expected earlier. This has resulted in large transfers to the Government Petroleum Fund and the Fund is expected to show substantial growth in the years ahead. Hence, there is a need for a clear strategy for the use of petroleum revenues over the Fiscal Budget over the next years. The objective of stable developments in the Norwegian economy implies, however, that there are clear limitations as to how fast an increase in the use of petroleum revenues can be phased in. The bulk of the large Fiscal Budget surpluses should thus be transferred to the Government Petroleum Fund to cover the increase in expenditure associated with the sharp rise in the number of old-age pensioners in the period following 2015. One of the primary objectives of the Government Petroleum Fund is in effect to separate the use of petroleum revenues from their accumulation, cf. Box 2.1.

Box 2.1 The Government Petroleum Fund

The Government Petroleum Fund was established in 1990 with a view to safeguarding long-term considerations in the use of petroleum revenues. The Fund's income is the net cash flow from petroleum activities and the return on the Fund's capital, while the Fund's expenses comprise a transfer to the central government budget to cover the non-oil budget deficit.

Transfers to the Fund comprise the capital remaining when the Storting has decided the share to be used for consumption and investment over the central government budget. The Fund thus makes government financial saving more visible, and the Fund's capital is invested abroad in its entirety.

In the Revised National Budget for 1995, the macroeconomic implications of the Fund were assessed. Emphasis was placed on the following:

- The Government Petroleum Fund is based on the depletion and sale of non-renewable natural resources. The Fund provides a means of accumulating alternative assets that can generate a return over a longer period, and that can also benefit future generations.
- Revenues from the petroleum sector vary more widely over time than other revenues. A fund arrangement makes it easier to separate the annual use of petroleum revenues from current revenues.
- The domestic use of petroleum revenues for consumption or fixed investment easily leads to rising price and cost inflation and a deteriorating basis for traditional exposed industries. By the same token, a sharp decrease in the use of revenues may lead to restructuring problems.

End Box

Developments in the composition of the population and pensions imply higher government budget expenditure in the years ahead. The Long-Term Programme for 2002-2005 presents macroeconomic projections, in the baseline scenario, which illustrate the challenges at hand. The projections describe a path for the Norwegian economy where growth in public employment is limited to achieve balanced growth that is sustainable in the long term. This path provides room for growth in public employment that is largely consistent with maintaining current public welfare standards and coverage, including approved reforms. With a continuation of the current social security regulations, unchanged tax rates and user fees for public services, the projections show a relatively small increase in the use of petroleum revenues, as measured by the structural, non-oil Fiscal Budget deficit (cf. Box 2.2), in the period to 2020. However, the deficit shows a strong increase in the period between 2020 and 2040 as a result of an increase in pension expenditure and other expenditure associated with the ageing of the population. In this scenario, there is no room for any new reforms or enhancement of public welfare services. This may entail strong pressures leading to increased demand for private services, e.g. private health services.

The baseline scenario illustrates that if policy is not revised in a way that contributes to enhancing public sector efficiency or strengthening general government budgets, there will not be scope for using more petroleum revenues in the coming years than what follows from approved reforms. This result is in keeping with the generational accounts which are now approximately in balance.

The basis for strengthening and expanding existing public welfare schemes will primarily depend on the growth capacity of the mainland economy, the maintenance of a labour force at a high level, and the renewal of the public sector so that more welfare is achieved at given resource inputs. Reference is made to the section on the renewal scenario in the Long-Term Programme for 2002-2005, and the final section of this chapter.

Chart 2.1 compares developments in the baseline scenario with the developments in the crowding out scenario and a scenario where the use of petroleum revenues over the Fiscal Budget is limited to the expected real return on the Government Petroleum Fund. The scenarios are also presented in the Long-Term Programme for 2002-2005. The crowding out scenario illustrates the consequences of increasing public service employment in pace with growth over the past ten years, while continuing to pursue today’s policy in key areas such as the pension system and taxation.

A guideline based on the use of petroleum revenues equivalent to the real return on the Government Petroleum Fund over the Fiscal Budget was discussed in the report of the Petroleum Depletion Commission in 1983. The projections presented in Chart 2.1 imply a gradual increase in the use of petroleum revenues up to 2020. The projections are based on the assumption that these revenues are used partly to increase public sector employment and partly to reduce taxes.

Chart 2.1 Fiscal Budget non-oil deficit and public sector employment

Chart 2.1 shows developments in the use of petroleum revenues over the Fiscal Budget and in public sector employment. Employment developments are illustrated by the difference between public employment in the various scenarios and the employment level necessary to implement approved welfare reforms and otherwise maintain current standards and coverage for public welfare services. The chart illustrates some of the main mechanisms associated with the phasing in of petroleum revenues:

- By allocating sufficient capital to the Petroleum Fund to meet future expenditure growth associated with the ageing of the population and future pension expenditure, it is possible to ensure a steady growth in public welfare services without the need for tightening spending in other areas, cf. developments in the *baseline scenario*. This scenario implies that the use of petroleum revenues increases relatively slowly over the next 20 years, followed by a sharp increase.
- With a continuation of growth in public sector employment in line with that of the 1990s, the non-oil deficit will increase rapidly, and necessitate a sharp tightening in public finances some time ahead, cf. development in the *crowding out scenario.* Such a rapid increase in the use of petroleum revenues in the years ahead will be matched by higher real wage growth and a scaling back of exposed sectors. This deterioration in competitiveness will subsequently have to be reversed. The petroleum revenues will in this case to a large extent have been depleted over the next 20 years, and imports of goods and services must again be financed primarily through exports from the mainland economy.
- *The use of the expected real return on the Government Petroleum Fund* implies a steady phasing in of petroleum revenues. This scenario ensures that this part of government wealth is not depleted, while providing room for some expansion of welfare services and /or some reduction in taxes. However, such a phasing in will also require the implementation of measures that contribute to limiting growth in general government spending or that enhance revenues. The scale of the necessary tightening ensuing from this scenario will, however, be substantially smaller than in the crowding out scenario.

A guideline for fiscal policy has so far been that the budget shall have an approximately neutral impact on the economy in a normal cyclical situation. This implies an unchanged use of petroleum revenues as measured by the structural, non-oil budget balance. All the different scenarios shown in Chart 2.1 imply an increased use of petroleum revenues. This illustrates that maintaining a *neutral fiscal stance*, i.e. unchanged use of petroleum revenues, will be very demanding in the long-term.

The analysis above illustrates that the question of what share of petroleum revenues is appropriate to use in the years ahead is not a question of *whether* to use more petroleum revenues over government budgets, but *when* this should take place. In the assessment of how petroleum revenues should be phased in over the years ahead, the following considerations are central:

a) The need for *steady growth in public services* implies, in isolation, substantial restraint in the use of petroleum revenues over the next two decades. The petroleum revenues saved can then be used to cover higher future expenditures, particularly after 2020. A strong increase in the use of petroleum revenues in this period could, however, lead to strong price and cost inflation during these years, and lead to considerable restructuring problems for the internationally exposed sector in this period.
b) The need to achieve stable economic developments over time, both before and after 2020, points to a fairly *steady phasing in of petroleum revenues*. The more the use of petroleum revenues is increased over the next ten years, the greater the need will be to strengthen government budgets at a later stage in order to achieve steady growth in public services.
c) *The aim of maintaining an internationally exposed sector and avoiding wide-scale restructuring in the economy* are of particular importance. Increased use of petroleum

revenues may increase economic activity. In a situation with high capacity utilisation, this could lead to a weakening of internationally exposed industries. When phasing in petroleum revenues, particular emphasis must thus be placed on maintaining a strong internationally exposed sector with a view to promoting long-term balanced growth in the Norwegian economy. Both our experience and that of other countries show that an excessive use of petroleum revenues can result in substantial restructuring costs and unemployment problems (Dutch disease).
d) *The uncertainty associated with future petroleum revenues* suggests that considerable caution should be applied to their use.
e) *Economic policy should not be based on tax increases.* To the contrary, some of the margin for manoeuvre ensuing from an increased use of petroleum revenues should be used over time to reduce taxes and excise duties. A high tax level is associated with social costs such as a reduction in the labour force. In an ever-more integrated world, the possibilities for maintaining a tax level that deviates also from other countries are substantially limited.

It is the Government's assessment that the use of petroleum revenues must be consistent with an economic policy that provides reasonable generational balance, the maintenance of public services in the long-term and an internationally exposed sector of a scale that ensures balance in the external account over time. Hence, a substantial share of the current large surpluses must be set aside to cover future expenditure. The use of petroleum revenues must be separated from their accumulation by transferring the bulk of the substantial petroleum revenues in the years ahead to the Government Petroleum Fund. Moreover, in the light of the uncertainty associated with future revenues, it is important that the use of revenues allows for a fall in oil prices.

Petroleum revenues have been substantially higher over the past two years than assumed earlier. This has resulted in large transfers to the Government Petroleum Fund, and increased the scope for using the return on the capital in the Fund. The Petroleum Fund is also projected to show considerable growth in the years ahead. This has increased the scope for manoeuvre in fiscal policy. The Government is of the view that against this background there is a need for a clear, long-term strategy for the use of petroleum revenues.

The Government emphasises that a guideline for the use of petroleum revenues that safeguards the considerations highlighted above must also be fairly simple and should be able to provide a reference for the budget process. A feasible approach would be to use a share that is approximately equivalent to the expected real return on the Government Petroleum Fund. A policy based on using the expected real return on the Government Petroleum Fund ensures that the real value of the Fund is not reduced. When all the revenues deriving from petroleum activities are transferred to the Government Petroleum Fund, and the use of revenues is limited to the return, the Fund will continue to grow in the years ahead. Moreover, the use of revenues is based on realised revenue flows from petroleum activities, and not on uncertain future revenues.

On the basis of an overall assessment, the Government will apply the following guidelines for fiscal policy:

- Considerable emphasis must be placed on stabilising fluctuations in the economy with a view to ensuring appropriate capacity utilisation and low unemployment.
- Petroleum revenues are gradually phased into the economy, approximately in pace with the expected real return on the Government Petroleum Fund.

Based on the estimates in the Long-Term Programme, this implies a use of petroleum revenues over the Fiscal Budget equivalent to about 5½ per cent of mainland GDP in 2010. In 2001, the corresponding share is close to 2 per cent, as measured by the structural, non-oil budget deficit. Adjustments have been made for variations in tax revenues associated with economic activity, accounting factors and some extraordinary, temporary revenues and expenditure, cf. Box 2.2. The guideline implies an estimated increase in the use of petroleum revenues over the Fiscal Budget of about 0.4 per cent of mainland GDP in each year up to 2010. For 2002, the guideline implies an increase in the use of petroleum revenues of NOK 4 billion compared with a neutral fiscal stance.

With a use of petroleum revenues equivalent to the expected real return on the Government Petroleum Fund, the Fiscal Budget surplus is estimated at 6 per cent of GDP in 2010, and the capital in the Government Petroleum Fund will increase to almost 130 per cent of GDP in 2010, cf. Chart 2.2.

The value of the Government Petroleum Fund will depend on developments in oil prices and the return on the Fund. Adverse effects could occur if wide fluctuations in the Fund's return were to feed through to the mainland economy as a result of changes in the use of petroleum revenues over the Fiscal Budget. In order to counter any such fluctuations, the *expected* real return on the Fund, and not the *actual* return, should be the basis for the phasing in of petroleum revenues. The expected real return has been estimated based on a real interest rate of 4per cent. In addition, the size of the Fund at the start of the fiscal year has been taken into account. In the event of extraordinary, substantial changes in the Fund's capital or in the structural, non-oil deficit from one year to the next, the change in the use of petroleum revenues must be distributed over several years based on an estimate of the size of the real return on the Fund a few years ahead.

Box 2.2 The structural, non-oil budget balance

Since the National Budget for 1987, the Ministry of Finance has used changes in the so-called non-oil, cyclically adjusted budget balance net of interest payments as an indicator of the fiscal policy stance. The indicator excludes revenues and expenditure that are not assumed to influence the level of activity in the economy. The non-oil, cyclically adjusted budget surplus net of interest payments is calculated by adjusting the non-oil surplus on the Fiscal Budget for interest flows between the state and Norges Bank and between the state and abroad, in addition to transfers from Norges Bank to the Fiscal Budget, revenues and expenditure that can be linked to the prevailing cyclical situation and some accounting factors, e.g. changes in accounting methods for the Fiscal Budget.

In order to provide a measure for evaluating the share of petroleum revenues that is used over the Fiscal Budget, two changes have been made in the calculations compared with earlier. Adjustments are now only made for the deviation between the normal level of transfers from Norges Bank and actual transfers. The normal level is estimated at around NOK 4 billion. Likewise, adjustments are only made for the deviation between the normal level and the actual level of government net interest income from Norges Bank and abroad. The normal level of net interest income is estimated at about NOK 4½ billion. The change only influences the level of the non-oil, cyclically adjusted budget deficit net of interest payments, and not changes from one year to the next. The new level estimates can be interpreted as the *structural, non-oil budget balance.* The structural, non-oil budget deficit is estimated at close to NOK 20 billion in 2000, or 1.9 per cent of trend mainland GDP. With a neutral budget in 2001, in keeping with the Storting's resolution, the structural, non-oil deficit will be at about the same level this year.

The *non-oil, cyclically adjusted budget indicator net of interest payments* shows the change in the structural, non-oil budget surplus, cf. last line in Table 2.1.

Table 2.1 The structural, non-oil budget balance and the non-oil, cyclically adjusted budget indicator net of interest payments. In millions of NOK

	1999	2000
Non-oil surplus on the Fiscal Budget	-12 066	-10 321
-Transfers from Norges Bank in excess of estimated trend level	-444	6 764
- Net interest income from Norges Bank and abroad in excess of estimated trend level	-3 499	-2 450
- Extraordinary accounting factors	1 770	-6 712
- Cyclical adjustments	10 392	11 844
= Structural, non-oil surplus	-20 285	-19 767
Measured as a percentage of trend mainland GDP	-2.1	-1.9
Change on previous year (non-oil, cyclically adjusted budget indicator net of interest payments)		0.2

Source: Ministry of Finance

End Box

Chart 2.2 Capital in the Government Petroleum Fund at year-end. As a percentage of GDP

The guidelines for the use of petroleum revenues are based on a normal cyclical situation. In a situation with high activity in the economy, the fiscal stance should be tightened accordingly, while a downturn may necessitate an increase in the use of petroleum revenues. Consequently, fiscal policy must continue to have a main responsibility for stabilising developments in the Norwegian economy.

Petroleum revenues must be used in an appropriate manner. Mainland output accounts for about 4/5 of total output in the Norwegian economy. Even a small reduction in income in the *rest of the economy* is enough to exhaust the increased room for manoeuvre provided by petroleum revenues. In the long term, it is thus the growth capacity of the mainland economy that determines the welfare services in Norway. This means that it is the size and use of the labour force and other resources that are the main determinants of economic growth and hence the scale of public welfare services. The Government places particular emphasis on using the margin for manoeuvre provided by increased use of petroleum revenues to strengthen the growth capacity of the Norwegian economy. Lower direct and indirect taxes can improve the operating environment for the business sector, with an attendant strengthening of competitiveness. Likewise, measures to enhance infrastructure, combined with the developments of new knowledge through research and development, will contribute to strengthening growth capacity. A stronger growth capacity and increased supply of labour will secure the basis for public welfare arrangements.

Reference is made to the Long-Term Programme for 2002-2005 for further details concerning the Government's policy to strengthen the growth capacity of the economy.

3 GUIDELINES FOR MONETARY POLICY

3.1 Background

In Norway monetary policy has traditionally been oriented towards maintaining a fixed or stable exchange rate. Experience has shown that it is difficult to fine-tune the exchange rate. In its conduct of monetary policy, Norges Bank has thus focused on the fundamental precondition for stability in the exchange rate, e.g. the inflation outlook and cyclical developments. In Norges Bank's submission of 21 October 1999 to the Ministry of Finance on economic policy in 2000, the Bank wrote:

> "In exercising its judgement, Norges Bank focuses on the fundamental preconditions for stability in the krone exchange rate: In order to achieve exchange rate stability against the euro, monetary policy instruments must be oriented in such a way that price and cost inflation is brought down towards the corresponding aim for inflation of the European Central Bank (ECB). At the same time, monetary policy must not in itself contribute to deflationary recessions, as this would undermine confidence in the krone".

When monetary policy is oriented towards an exchange rate objective, inflation in Norway can only be permitted to deviate to a limited extent from inflation in the country of the anchor currency. A precondition for a stable exchange rate against the euro is that inflation is approximately in line with that of the euro area over time. The European Central Bank has defined price stability as a rate of increase in prices of 2 per cent or lower, cf. box 3.1.

For a small, open economy, there is a close relationship between exchange rate developments and domestic inflation. Exchange rate stability can contribute to expectations of continued low inflation, which in turn influence both price and wage setting. Stable economic developments, with moderate price and cost inflation, are also a precondition for stable exchange rate developments over time.

In his annual address delivered on 17 February 2000, the Governor of Norges Bank stated the following:

> " The experience of the 1970s and 1980s shows that monetary policy cannot in the long run steer competitiveness or the size of the exposed sector. If we attempt to do so, monetary policy only contributes to instability. Such real economic fundamentals may, on the other hand, be influenced through fiscal policy and cooperation between the social partners. Norges Bank cannot with open eyes contribute to higher inflation or a deflationary recession. This would contribute to an unstable krone. Hence, there is no conflict between gearing monetary policy instruments towards low and stable inflation and the objective of a stable krone exchange rate over time."

Box 3.1 Monetary policy objectives in selected countries

USA **The Federal Reserve System** shall, in its conduct of monetary policy, seek to promote the goal of maximum employment, stable prices and moderate long-term interest rates. The Chairman of the Federal Reserve System, Alan Greenspan, has referred to price stability as inflation that is so low that it does not influence agents' behaviour.

Canada	**The Bank of Canada** has, in consultation with the government, established an inflation target. In 1998 the inflation target was set at 1-3 per cent as measured by the consumer price index.
Australia	**The Reserve Bank of Australia** has, in consultation with the government, established the objective of maintaining underlying inflation between 2 and 3 per cent on average over the business cycle.
New Zealand	**The Reserve Bank of New Zealand** shall maintain price stability. In consultation with the government, this is defined as annual inflation between 0 and 3 per cent as measured by the consumer price index.
Japan	**The Bank of Japan's** missions are to maintain price stability and to ensure the stability of the financial system, thereby laying the foundations for sound economic development.
Euro area	**The European Central Bank's** main objective is the maintenance of price stability. The Bank has defined price stability as an annual rate of increase in the Harmonised Index of Consumer Prices (HICP) of below 2 per cent for the euro area.
UK	**The Bank of England** has an inflation target of 2½ per cent. The target is established by the government and is measured by the RPI (retail price index) excluding mortgage interest rates. If inflation deviates by more than 1 percentage point from the target, the central bank provides an assessment.
Sweden	**The central bank of Sweden** has a price stability objective. Price stability is defined as inflation of 2 per cent as measured by the consumer price index, with permitted deviations of +/- 1 percentage point.
Denmark	**The central bank of Denmark** is responsible for supporting Denmark's fixed-exchange rate policy against the euro, which is regulated through ERM II cooperation, with permitted fluctuation margins within an interval of +/- 2.25 percentage points around the central rate.
Iceland	**The central bank of Iceland** and the government have established price stability as the objective of monetary policy. The Bank shall aim at annual price inflation of 2.5 per cent within an interval of +/- 1.5 percentage points around this rate.
Switzerland	**The Swiss National Bank** is to act in accordance with the interests of the country as a whole. The Bank considers price stability to be a primary goal, and has defined inflation under 2 per cent as the target, as measured by the consumer price index.

End Box

An effective interplay between the various components of economic policy is essential to achieve stable economic growth, a stable exchange rate and low inflation. This was underlined in the Revised National Budget for 1994 when the former exchange rate regulation was laid down:

> "An overall assessment of the economic policy instruments should be made based on the primary objectives. High employment and low price and wage inflation require a successful coordination of monetary policy, fiscal policy, incomes policy and measures to improve the functioning of the economy. Combined with other policy instruments, monetary policy should be geared towards achieving stable economic growth."

This assessment still applies.

Fiscal policy has a main responsibility for stabilising developments in the Norwegian economy. Monetary policy partially eases the burden on fiscal policy in stabilising the economy, but caution should be exercised in placing an excessive burden on monetary policy. The central government budget accounts for such large share of the overall economy that in practice it is impossible to achieve stable economic growth without fiscal policy assuming a main responsibility.

In its submission of 19 October 2000, Norges Bank stated the following with regard to economic policy in 2001:

> "A special situation arises if fiscal policy stimulates higher growth in demand for goods and services from sheltered industries while there are still considerable pressures in the economy. In this situation, the contest for economic resources must inevitably result in deteriorating competitiveness and a reduction in value added in the internationally exposed sector. If there is little confidence in Norwegian economy policy, this may result in expectations of higher inflation and an unstable exchange rate. Norges Bank must counter any developments that in this way would erode the fundamental preconditions for exchange rate stability. If, on the other hand, there is confidence that monetary policy is geared towards fulfilling these fundamental preconditions, i.e. that monetary policy will not inflate the economy, market agents might expect a deterioration of cost competitiveness through an appreciation of the krone. Norges Bank would not be able to counter such an appreciation without generating inflation. Norges Bank’s first response when it sees such pressures building up would be to recommend changes in the government budget. However, if an appreciation of the krone should reflect a political desire to expand public sector activity, and this is assigned higher priority than continued growth in activities exposed to international competition, it would also be appropriate to consider a revision of the guidelines for monetary policy, as communicated in Norges Bank’s budget submission of 21 October 1999."

Norway is now in a period where fiscal policy is also to accommodate a gradual and sustainable increase in the use of petroleum revenues in the Norwegian economy. This must take place while placing particular emphasis on securing a continued strong internationally exposed sector and long-term balance in the Norwegian economy.

In this situation, the Government finds that it is necessary to establish a clearer anchoring of monetary policy's role in underpinning economic stability. The Government is of the view that this can best be achieved by aiming at stability in the internal and external value of the

Norwegian krone. Monetary policy shall also underpin fiscal policy by contributing to stabilising developments in output and employment. The implementation of monetary policy shall, in keeping with this, be oriented towards low and stable inflation, defined as annual consumer price inflation of approximately 2.5 per cent over time. As a main rule, consumer price inflation is expected to remain within an interval of +/-1 percentage point around the target. The conduct of monetary policy shall be forward-looking and temporary disturbances that are not considered to have an effect on underlying price and cost inflation should not be taken into account.

The new guidelines for monetary policy imply that Norges Bank shall exercise a professional, delimited judgement within the scope of its mandate. The new guidelines represent a change in the Bank's mandate, but should not imply a significant change in the orientation of monetary policy instruments. Hence, the guidelines imply continuity in the conduct of monetary policy, and will provide a sound basis for Norges Bank to continue its conduct of a monetary policy that enjoys the confidence of financial markets and society at large. The new guidelines for monetary policy, combined with the guidelines for fiscal policy that are drawn up in this report, will provide a solid basis for maintaining stability in the exchange rate.

3.2 New guidelines for monetary policy

New monetary policy guidelines are established by Royal Decree of 29 March 2001, cf. box 3.2. In the following, some comments on the various provisions of the regulation are provided.

Ordinary consultation procedure was not carried out prior to the issuance of the regulation as it was considered that this could have complicated the implementation of the regulation or could have weakened its effectiveness, cf. §37 of the Public Administration Act. Norges Bank was given the opportunity to issue an opinion prior to the issuance of the regulation, cf. §2 of the Act on Norges Bank and the Monetary System. In its submission of 27 March 2001 (see Annex 2 in this report), Norges Bank indicates that it does not object to the draft regulation. The Bank wrote:

> "Pursuant to its existing mandate, Norges Bank has oriented monetary policy instruments with a view to bringing price and cost inflation down towards the corresponding aim for inflation of the European Central Bank. There has been confidence in the conduct of monetary policy. The communication of Norwegian monetary policy may nevertheless be facilitated with the Government now quantifying an inflation target, in line with international practice."

§1, first paragraph, reads: " Monetary policy shall be aimed at stability in the Norwegian krone’s national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment." Over time there will normally be a clear relationship between developments in the krone's purchasing power in Norway and developments in the value of the krone measured against our trading partners. A stable exchange rate can contribute to expectations of continued low inflation, which in turn influences price and wage setting. Stable economic growth, with moderate price and cost inflation, is also a precondition for stability in the exchange rate over time.

§1, third paragraph, of the regulation reads: "Norges Bank’s implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time." As a main rule, consumer price inflation is expected to remain within an interval of +/-1 percentage point around the inflation target. The provision is to be construed to mean that deviations between actual inflation and the target in a period shall not be compensated for in a later period. If inflation deviates significantly from the target over a period, Norges Bank shall set the interest rate with a view to returning gradually consumer price inflation to the target to avoid unnecessary fluctuations in output and employment.

§1, fourth paragraph, of the regulation reads: "In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account." Norges Bank's interest rate setting shall be forward-looking and take due account of the uncertainty associated with macroeconomic estimates and assessments. It shall take into account that it can take time for policy changes to have an impact, and disregard disturbances of a temporary nature that are not considered to have an effect on underlying price and cost inflation. As a rule, monetary policy shall not react to direct effects on inflation that are due to changes in interest rates, taxes, excise duties and extraordinary temporary disturbances.

§2 of the regulation reads: 'Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy." The Bank now publishes reports three times a year, which the Ministry of Finance considers to be adequate. The Ministry expects Norges Bank to provide an assessment of any failure to reach the target established. In its submission of 27 March, the Bank wrote:

> " If there are significant deviations between actual price inflation and the target, the Bank will provide a thorough assessment in its annual report. Particular emphasis will be placed on any deviations outside the interval +/- 1 percentage point.

The Ministry has taken note of this. Other circumstances may also require such an assessment on occasions other than the annual report.

In accordance with the above, the Government has today issued a new regulation on monetary policy by Royal Decree, pursuant to §2, third paragraph, and §4, second paragraph, of the Act on Norges Bank and the Monetary System, cf. box 3.2.

Box 3.2 Regulation on Monetary Policy

Established by Royal Decree of 29 March 2001 pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act of 24 May 1985 no. 28 on Norges Bank and the Monetary System

I

§ 1.
Monetary policy shall be aimed at stability in the Norwegian krone’s national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

§ 2.
Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy.

§ 3.
The international value of the Norwegian krone is determined by the exchange rates in the foreign exchange market.

§ 4.
On behalf of the State, Norges Bank communicates the information concerning the exchange rate system ensuing from its participation in the International Monetary Fund, cf. Section 25, first paragraph, of the Act on Norges Bank and the Monetary System.

II

This regulation comes into force immediately. Regulation no. 0331 of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.
End Box

3.3 Other questions

In its submission of 27 March 2001, Norges Bank also refers to fiscal policy and the internationally exposed sector:

> " Norges Bank concurs that there must be a sound interplay between fiscal policy and monetary policy to ensure stable economic developments. It would be advantageous if fiscal policy could be used to counter fluctuations in demand and production.
>
> Norges Bank would assert that a gradual phasing in of petroleum revenues approximately in step with the expected real return of the Petroleum Fund will, ceteris paribus, contribute to deteriorating conditions for businesses exposed to international competition.
>
> The Norwegian economy and government finances are influenced by large and varying revenues from petroleum activities. The basis for determining central government expenditure and taxes from one year to the next may then easily be impaired. If budget spending is allowed to vary in step with oil prices, the Norwegian economy may experience abrupt shifts and instability. Changes in oil prices could then quickly influence wage and price expectations, the exchange rate and long-term interest rates. In that case it would be very demanding to achieve nominal stability. Short-term interest rates would then have to be changed frequently and sharply and will generally reflect an increased risk premium on the Norwegian krone, which over time would result in a generally higher interest rate level. Norges Bank would

> therefore emphasise the importance of establishing broad consensus concerning a credible long-term anchor for fiscal policy which takes into account that oil prices may fluctuate from one year to the next."

The Government finds that a guideline on using the expected real return on the Government Petroleum Fund provides a credible and long-term anchor for fiscal policy. This implies a steady and cautious use of petroleum revenues, thereby contributing to stable developments in the Norwegian economy. Fiscal policy shall continue to place considerable emphasis on stabilising fluctuations in the economy. Fiscal policy must continue to have a main responsibility for stabilising the economy.

The guideline on using the real return implies that substantial emphasis is placed on maintaining a strong internationally exposed sector and avoiding extensive restructuring of the economy.

Moreover, the Government places considerable emphasis on strengthening the growth capacity of the Norwegian economy, both in the private and public sector. The work approach, the renewal of the public sector, and structural policy measures to strengthen the business sector will lay the foundations for an increase in output in all sectors of the economy, also in the manufacturing sector.

The Ministry of Finance

recommends:

The recommendation of the Ministry of Finance of 29 March 2001 on the Guidelines for Economic Policy be submitted to the Storting.

Annex 1

Guidelines for monetary policy

Letter from the Ministry of Finance to Norges Bank of 26 March 2001

1
In the Government's Long-Term Programme for 2002-2005, fiscal policy will be subject to the following guidelines:

- Considerable emphasis must continue to be placed on stabilising fluctuations in the economy with a view to ensuring appropriate capacity utilisation and low unemployment.
- Petroleum revenues are gradually phased into the economy, approximately in pace with the expected real return on the Government Petroleum Fund.

This implies a moderate increase in the phasing in of petroleum revenues in the years ahead.

Fiscal policy shall continue to have a main responsibility for stabilising developments in the Norwegian economy. At the same time, petroleum revenues shall be phased into the Norwegian economy gradually and in a sustainable manner, with considerable emphasis on ensuring a continued strong internationally exposed sector, contributing to long-term balance in the economy.

In this situation, there is a need for a clear, formal anchoring of monetary policy's role in underpinning stability in the economy. Monetary policy shall aim at maintaining stability in the Norwegian krone's internal and external value. Monetary policy shall also underpin fiscal policy by contributing to stabilising output and employment. The implementation of monetary policy shall, in keeping with this, be oriented towards low and stable inflation, defined as annual consumer price inflation of approximately 2.5 per cent over time. As a main rule, consumer price inflation is to remain within an interval of +/-1 percentage point around the inflation target.

The Minister of Finance will recommend a revision of the guidelines for monetary policy by laying down a new regulation by Royal Decree pursuant to §2, third paragraph, and §4, second paragraph, of the Act on Norges Bank and the Monetary System. The new guidelines for monetary policy will represent a formal change in Norges Bank's mandate, but will not imply a significant change in the orientation of monetary policy instruments. Hence, the guidelines will imply continuity in the conduct of monetary policy, and provide a sound basis for Norges Bank to continue its conduct of a monetary policy that enjoys confidence in the financial market and society at large. The new guidelines for monetary policy, combined with the guidelines for fiscal policy that are being drawn up, will provide a sound basis for continued stability in the exchange rate.

2
In the subsequent report to the Storting, it will be underlined that the overriding economic policy objectives remain unchanged: Full employment, an equitable distribution, the further development of the Norwegian welfare society and sustainable development. The various components of economic policy must be complementary to achieve these objectives. The central government budget accounts for such large share of the overall economy in Norway

that in practice it is impossible to achieve stable economic growth without fiscal policy assuming a main responsibility.

3
In accordance with the above, a new regulation will be issued by Royal Decree pursuant to §2, third paragraph, and §4, second paragraph, of the Act on Norges Bank and the Monetary System:

I

§ 1.
Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

§ 2.
Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy.

§ 3.
The international value of the Norwegian krone is determined by the exchange rates in the foreign exchange market.

§ 4.
On behalf of the State, Norges Bank communicates the information concerning the exchange rate system ensuing from its participation in the International Monetary Fund, cf. Section 25, first paragraph, of the Act on Norges Bank and the Monetary System.

II

This regulation comes into force immediately. Regulation no. 0331 of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.

4
The draft regulation is hereby submitted to Norges Bank for comment, cf. Norges Bank shall have the opportunity to issue an opinion before decisions concerning the Bank's activities are taken. The Ministry of Finance requests that any comments from Norges Bank be submitted no later than 5 pm, 27 March 2001.

Yours sincerely

Tore Eriksen
Secretary General

Øystein Olsen
Director General

Annex 2

Guidelines for monetary policy

Letter from Norges Bank to the Ministry of Finance of 27 March 2001

Norges Bank refers to the Ministry of Finance's letter of 26 March 2001 concerning the guidelines for monetary policy, enclosing a draft for a new regulation submitted to Norges Bank for comment.

The Bank does not object to the formal procedure, with the adoption of a joint regulation pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act on Norges Bank and the Monetary System.

The draft regulation states:

"…Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time."

The fundamental task of monetary policy is to provide the economy with a nominal anchor. Nominal stability is the best contribution monetary policy can make to economic growth and prosperity. A nominal anchor is also a necessary precondition for stability in financial markets and property markets.

Pursuant to its existing mandate, Norges Bank has oriented monetary policy instruments with a view to bringing price and cost inflation down towards the corresponding aim for inflation of the European Central Bank. There has been confidence in the conduct of monetary policy. The communication of Norwegian monetary policy may nevertheless be facilitated with the Government now quantifying an inflation target, in line with international practice.

The inflation target of 2.5 per cent is slightly higher than similar objectives for Sweden, Canada and the euro area, but corresponds roughly to targets in the United Kingdom and Australia. The target is also approximately in line with the average inflation rate in Norway in the 1990s.

Norges Bank is responsible for the implementation of monetary policy. In the light of developments in recent years, the application of the new guidelines will not result in significant changes in the conduct of monetary policy. Norges Bank's key rates will be set on the basis of an overall assessment of the inflation outlook. In the following, Norges Bank presents its understanding of the regulation and the consequences for its implementation of monetary policy.

Monetary policy affects the economy with considerable and variable lags. Consequently, the Bank must be forward-looking in its interest-rate setting. The effects of interest rate changes are uncertain and vary over time. Changes in the interest rate will be made gradually so that the Bank may assess the effects of interest rate changes and other new information on economic developments. If price inflation deviates substantially from the target for a period, Norges Bank will set the interest rate with a view to gradually returning consumer price inflation to the target. Norges Bank will seek to avoid unnecessary fluctuations in output and demand.

Consumer price inflation normally varies from month to month. Substantial changes in the inflation rate may at times occur as a result of extraordinary fluctuations in certain product markets or changes in direct and indirect taxes. In its analyses of different measures of underlying inflation, Norges Bank will assess the effects of changes in the interest rate level, taxes, excise duties and extraordinary temporary disturbances. Deviations between actual and projected underlying inflation will normally be in the interval +/- 1 percentage point.

Norges Bank places considerable emphasis on the transparency and communication of monetary policy. Analyses carried out by the Bank and the background for the Bank's decisions are published regularly. The Bank reports on the implementation of monetary policy in its annual report. If there are significant deviations between actual price inflation and the target, the Bank will provide a thorough assessment in its annual report. Particular emphasis will be placed on any deviations outside the interval +/- 1 percentage point.

The krone is floating, and the value of the krone fluctuates periodically, as do the exchange rates of other small and open economies. The best contribution monetary policy can make to stabilising exchange rate expectations is to aim at the objective of low and stable inflation. Changes in the Norwegian interest rate level have a predictable effect on the krone exchange rate only when they also contribute to low and stable inflation.

In its letter to Norges Bank, the Ministry of Finance states:

"In the Government's Long-Term Programme for 2002-2005, fiscal policy will be subject to the following guidelines:

- Considerable emphasis must continue to be placed on stabilising fluctuations in the economy in order to ensure appropriate capacity utilisation and low unemployment.
- Petroleum revenues will gradually be phased into the economy, approximately in step with the expected real return of the Petroleum Fund.

This implies a moderate increase in the phasing in of petroleum revenues in the years ahead.

Fiscal policy shall continue to have a main responsibility for stabilising developments in the Norwegian economy. At the same time, petroleum revenues shall be phased in gradually and in a sustainable manner in the Norwegian economy, with considerable emphasis on ensuring a continued strong internationally exposed sector, contributing to long-term balance in the economy.

In this situation, a clear, formal anchor is required to reinforce monetary policy's role in underpinning stable economic developments. …"

Norges Bank concurs that there must be a sound interplay between fiscal policy and monetary policy to ensure stable economic developments. It would be advantageous if fiscal policy could be used to counter fluctuations in demand and output.

Norges Bank would assert that a gradual phasing in of petroleum revenues approximately in step with the expected real return of the Petroleum Fund will, ceteris paribus, contribute to deteriorating conditions for businesses exposed to international competition.

The Norwegian economy and government finances are influenced by large and varying revenues from petroleum activities. The basis for determining central government expenditure and taxes from one year to the next may then easily be impaired. If budget spending is allowed to vary in step with oil prices, the Norwegian economy may experience abrupt shifts and instability. Changes in oil prices could then quickly influence wage and price expectations, the exchange rate and long-term interest rates. In that case it would be very demanding to achieve nominal stability. Short-term interest rates would then have to be changed frequently and sharply and will generally reflect an increased risk premium on the Norwegian krone, which over time would result in a generally higher interest rate level. Norges Bank would therefore emphasise the importance of establishing broad consensus concerning a credible long-term anchor for fiscal policy which takes into account that oil prices may fluctuate from one year to the next.

Yours sincerely

Svein Gjedrem

Jan F. Qvigstad