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ECONOMICS

The unbearable lightness of the krone

Marcello Minenna on why a weak currency reflects markets' lack of confidence in Norway's economic policy



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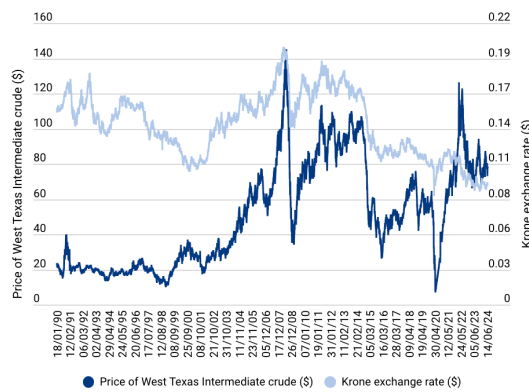


Norway is one of the world's richest nations, with GDP per capita of about \$100,000. It also now has the weakest currency of any developed western economy.

From the 1990s, when the country's hydrocarbons industry was consolidating its presence in global energy markets, the value of the krone was strongly influenced by oil prices. Norway has vast oil and natural gas reserves, and its energy sector accounts for more than one-third of GDP, more than 15% of investment and two-thirds of exports.

Yet for the past three years, the krone/dollar exchange rate has been decoupled from oil price movements, and there is a risk that Norway's currency will remain at its current weak level against the greenback.

Norway's currency has become uncoupled from international oil prices



Source: Bloomberg; data elaborated by the author
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The Labour party's return to power in October 2021 led to a more restrictive fiscal policy, including increased estate and inheritance taxes. This led many of Norway's wealthiest citizens to move abroad – if not physically, then at least fiscally. This capital flight has resulted in reduced tax revenues for the government and contributed to the decoupling of the exchange rate from oil price trends.

Nevertheless, the land of the Vikings maintains a positive trade balance, driven by oil and gas exports, and has been able to rebalance its economy by running significant budget deficits. Yet it remains a net importer of services – which, given the weak krone, means structurally imported inflation.

These developments have reduced the central bank's ability to control inflation by raising interest rates. It is no coincidence that since October 2021, Norges Bank has pursued severe tightening, and this policy finally seems to be producing results.

Monetary tightening is starting to have an impact on

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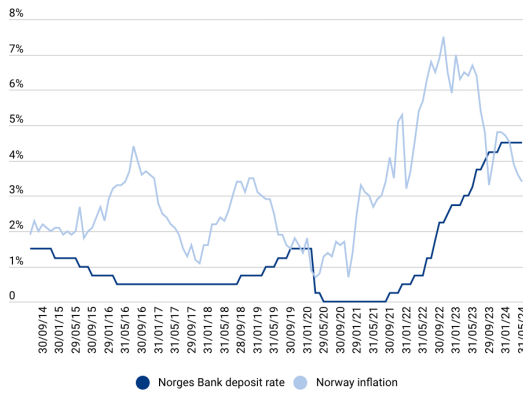
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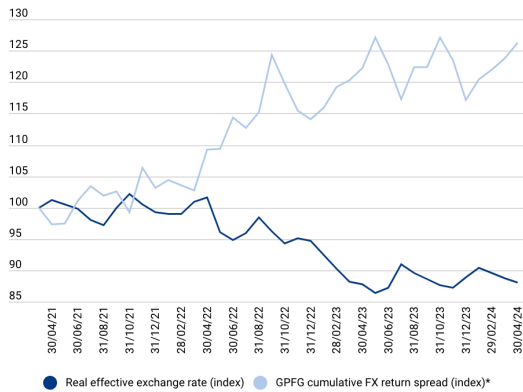
However, this emerging structural weakness on the part of the central bank has been counterbalanced by an abundant inflow of valuable foreign currency. This is reflected in the growth over the past four quarters in Norway's net international investment position (NIIP). The amount of foreign financial assets held by Norwegians is currently around \$1.7 trillion greater than the amount of Norwegian financial assets held by foreigners, and the figure is about to grow even further.

The Government Pension Fund Global (GPF), which was established in 1990 to help manage oil revenues and is now the world's largest sovereign wealth fund, accounts for more than 90% of this figure. The GPF manages assets worth more than \$1.5 trillion – more than three times Norway's GDP – and accumulated more than \$500 billion in income in 2023. The fund has become the real determinant of economic policy and the one institutional actor capable of stabilising balance-of-payments flows.

However, it is also evident that the weaker the krone, the more the GPF grinds out profits by holding assets denominated in foreign currencies. The positive change in the NIIP is the result of capital gains derived from the performance of financial markets and the devaluation of the domestic currency.

The government and central bank have "subcontracted" to the GPF the financial aspects underlying the political economy. This is clearly dysfunctional. Although the krone's weakness is correlated with a stronger performance by the sovereign wealth fund, it also reduces the international purchasing power of Norwegian firms and households.

As the currency's value has fallen, the sovereign wealth fund's has risen



* measures proportion of GPF returns arising from exchange rate

Source: Statistics Norway, Norges Bank, Norges Bank Investment Management; data elaborated by the author
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There is an increasing gap between the exchange rate and the cumulative FX return spread, which measures the GPF's return differential arising from the exchange rate component. This highlights the negative impact that the weak krone is having on Norway's public finances and its economy more broadly. Over the long term, the government cannot use the budget deficit, which currently amounts to 15% of GDP, to mitigate the impact – which goes beyond Norwegian families being less able to visit foreign countries or send their children to study abroad, though the effects of such dynamics on the broader domestic economy are not negligible.

If buying a currency means betting on a country's future, then the financial markets appear to have lost confidence in Norway's economic policy.

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