Economic perspectives

Address by Governor Svein Gjedrem at the meeting of the Supervisory Council of Norges Bank on Thursday, 14 February 2008

Introduction

Henrik Wergeland was born 200 years ago. He worked in the vicinity of the central bank in periods. His plays were performed at the Christiania Theatre, which was located at Bankplassen, and as national archivist his office was located at Akershus fortress, a stone's throw from the central bank.

Wergeland lived near Grønlia below Ekeberg. He travelled to town by rowing across Bjørvika. He moored his boat near Bekkevold's pub on Skippergata, which is today known as "Grei Kafé". That is also where he met the proprietor's daughter, Amalie Sofie, who became his wife.[1]

Wergeland wrote a poem "Follow the Call", which includes a well known verse:

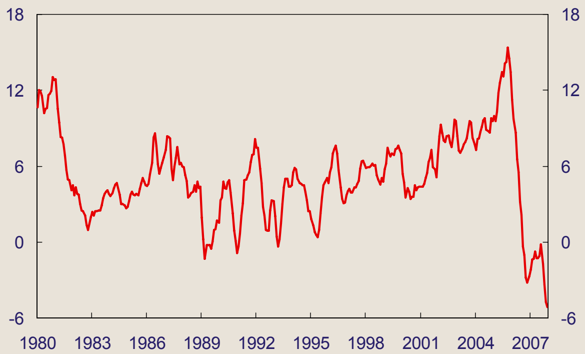
"But our world must still be young,
Saga of each race must be
still merely its cradlesong
and its childhood fairy tale.
Creatures from the age of chaos […]" [2]

Chaos and fear exploded with full force in the financial markets last autumn. We are again witnessing that market participants suffer from a short memory span.

Crises, imbalances and bubbles

House prices in the US started to fall in 2006 (Chart 1). There were reports of defaults on mortgage loans, but it was generally believed that the loans at risk were confined to a small segment of the market.

Chart 1 The US housing market. Price changes



Source: Reuters (EcoWin)

The chart shows the three-month moving average of twelve-month changes in the median price of resale homes in the US between January 1980 and December 2007.

The first warning of more severe problems came in winter last year. In the course of summer, it became clear that the losses had spread, and in the first instance to state-owned German banks. Other banks, funds and financial establishments in Europe, Asia and the US also felt the turbulence and gradually losses emerged where we perhaps least expected them.

A European colleague compared the financial turbulence to a film production: It was shot in the US, premiered in Germany and is now playing all over the world. As you know, it also came to small-town cinemas in Norway last autumn.

In addition to German banks, a small Danish bank and a fairly large British mortgage bank were faced with serious problems. At St James' Park in Newcastle, advertisements for the crisis-hit British bank Northern Rock shine towards us (Chart 2). We are indeed witnessing crises at banks in neighbouring countries.

The turmoil spread to money and credit markets in August. Few knew who was exposed to losses, and banks, funds and financial establishments started to question counterparties' financial situation, and held on to their money. This resulted in a surge in banks' premia on short-term interbank rates.

Moreover, banks had to bring back on their books loans from companies they had established, which further reduced their capacity and willingness to provide new loans. Several large foreign banks have received capital infusions from sovereign-wealth funds in the Middle East and Asia to bolster their financial strength.

What began as isolated losses in a small segment of the US home mortgage market led to a confidence crisis, which spread to money and credit markets in many countries in autumn 2007. In the US, there is a risk that the losses will increase in other segments of the property

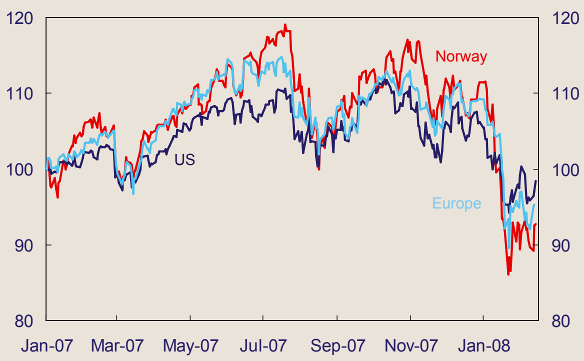
Chart 2 A bank in crisis: Northern Rock

Photo: AFP/SCANPIX

[1] Yngvar Ustvedt (1994) "Henrik Wergeland – En biografi", Gyldendal Norsk Forlag A/S.

[2] Source: www.dokpro.uio.no. Text from "Henrik Wergeland – Samlede skrifter", ed. Herman Jæger, Didrik Arup Seip, Halvdan Koht and Einar Høigård, published by Steenske Publishers, 1918-1940. Poem translated by Anne Born, published in "The Army of Truth", The University of Wisconsin Press.

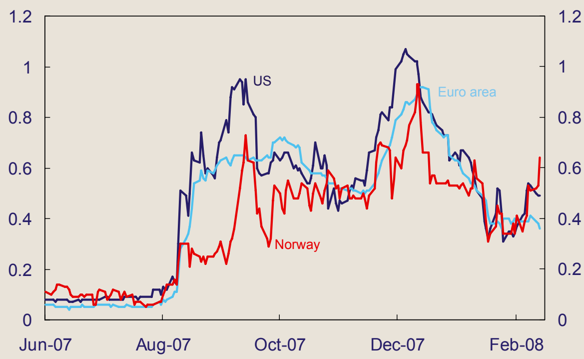
Chart 3 Equity prices. Indices, 1 January 2007 = 100



Source: Reuters (EcoWin)

The chart shows developments in Norwegian (OSEBX), US (S&P 500) and European (STOXX) equities between 1 January 2007 and 13 February 2008.

Chart 4 Interest rate premia in the money market. Percentage points



Sources: Bloomberg, Reuters (EcoWin) and Norges Bank

The chart shows the difference between the money market rate and expected key rate between 1 June 2007 and 13 February 2008. Expected key rate measured by Overnight Indexed Swaps (OIS).

market and on ordinary consumer and business credit. Many of the new financial instruments which were forged to diversify risk have proved to be non-viable. It is now difficult for many companies to raise new capital or procure long-term funding. There are also signs that prices and activity in property markets have reversed and are falling in many European countries.

Around the turn of the year, doubts were raised as to the financial strength of some US banks. The new year was ushered in amid fears of a setback in the US and a sharp decline in global equity prices (Chart 3). So far this year, the market capitalisation of the Oslo Stock Exchange has declined by more than 15 per cent, or more than NOK 300 billion.

When the interbank market seized up, many central banks injected extra liquidity. In periods, Norges Bank has also provided additional loans to banks. This has reduced swings in interbank rates.

Norwegian banks borrow dollars short in the European market for their interbank trading. Banks also borrow in foreign markets to finance lending in NOK. The banks raise foreign currency loans, which are exchanged into NOK. The premia on such loans (Chart 4) are passed on to customers that borrow in NOK. This is why the increase in US and European premia has quickly fed through to Norwegian interest rates even though Norwegian banks are profitable, retain confidence and have limited loss exposures.

In recent years, debt accumulation among Norwegian businesses and households has increased markedly. At the same time, Norwegian banks' foreign short-term liabilities have tended upwards. The banks hedge against the exchange and interest rate risk associated with these loans. But the turbulence in the latter half of last year showed that banks cannot as readily hedge against liquidity risk.

Norges Bank supplies NOK to the Norwegian banking system. In that respect, we can be generous when the markets are seized by fear and uncertainty. But when banks borrow in foreign currency, they are more on their own.

Crises and turbulence are built into the workings of the market. The search for yield and market shares may at times become too intense. A common feature of financial crises is that they are accompanied by considerable changes in the pricing of risk in many markets. Prices for equities and other securities are determined by economic agents' income expectations. On occasion, these expectations turn out to be unrealistic. Unexpected events can change the economic outlook. When confidence and optimism shift to fear and uncertainty – and this can happen overnight – prices can rapidly plummet.

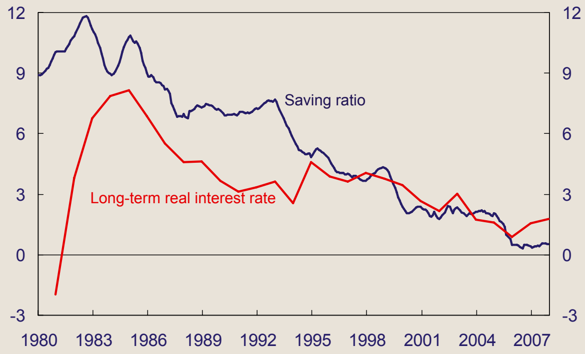
The current turbulence has deep roots. US household saving fell markedly in the 1990s. When the dotcom bubble burst after the turn of the millennium, the Federal Reserve cut its key rate to low levels. Interest rates in Europe also showed a considerable decline. House prices and investment in real property then rose sharply through most of the Western world, and saving in the US and other Western countries showed a renewed fall.

Low government and personal saving in the US has given rise to large trade deficits (Charts 5 and 6). The saving of the rest of the world is financing the US deficit. In isolation, such a large supply of capital would have required higher interest rates. But even though the US increasingly had to rely on foreign financing, long-term interest rates fell. At the same time inflation remained low, partly thanks to cheap Asian imported goods.

The low level of long-term interest rates can be attributed to the high level of saving in Asia and oil-exporting nations. Surpluses, particularly on China's foreign trade balance, have soared (Chart 7)

Interest rates are again moving down in the US and a number of other countries. Interest rates are being cut to address weaker economic growth prospects. However, in view of the high level of unsold homes and properties, it is uncertain whether the interest rate weapon will be as powerful as in the past.

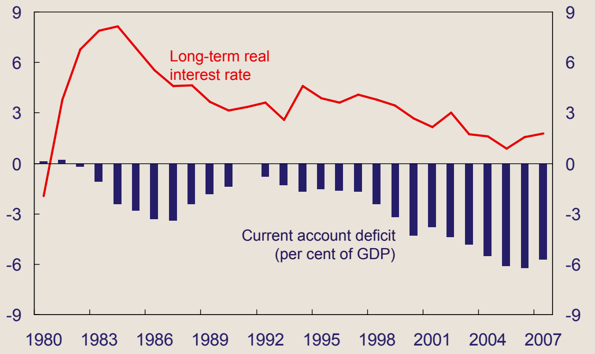
Chart 5 Real interest rate and saving ratio in the US. Per cent



Source: Reuters (EcoWin)

The Chart shows changes in long-term interest rates (10 years) and household saving as a percentage of disposable income in the US between January 1980 and December 2007.

Chart 6 US real interest rate and current account deficit. Per cent



Sources: Reuters (EcoWin) and IMF

The chart shows the current account surplus for China, Japan and oil exporters. Figures for 2007 and 2008 are estimates. The oil-exporting countries included are Algeria, Iran, Kuwait, Mexico, Nigeria, Norway, Russia, Saudi Arabia, United Arab Emirates and Venezuela.

Thus, there is a risk that the US economy will enter into a prolonged downturn in spite of the interest rate cuts, drawing with it large parts of the world economy. In the event, the surpluses in Asia will decline as the value of exports falls.

Moreover, there is a risk that low interest rates may in the next round sow the seeds of new bubbles, restrain saving in the US and extend the period of large US current account deficits.

The optimal solution would be to redress this imbalance through an increase in US saving. In order to buoy up growth in the world economy, Asia and Europe must then replace US consumers as the engine of global growth. The prospects for achieving this are perhaps not the best. Inflation is on the rise in both Europe and Asia, and this will necessarily be reflected in economic policy, at least for a period ahead. Moreover, the absence of a social safety net in China creates a strong incentive for Chinese consumers to save rather than spend.

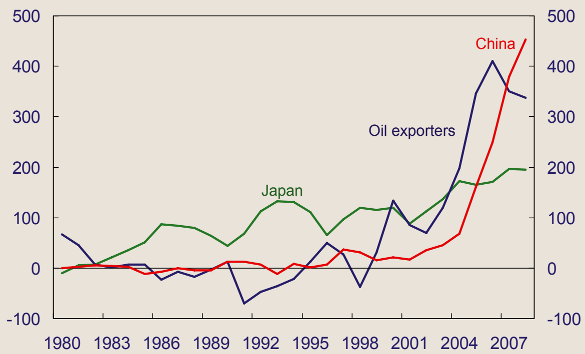
Is the Norwegian economy also at a turning point?

Household saving has also been low in Norway in recent years and corporate earnings have been offset by high investments. Excluding government financial and oil sector surpluses – which are redeployed abroad – Norway recorded a current account deficit of an estimated NOK 150 billion in 2007, or close to 10 per cent of mainland GDP (Chart 8).

The corollary to the deficit on the basic balance is that Norwegian businesses, as well as Norwegian banks, borrow in foreign markets. It is the interaction between high household credit demand and an ample supply of credit that has resulted in low saving and large deficits.

The banks now have to put more effort into procuring deposits and a little less into selling loans. Such a change in banks' behaviour may contribute to curbing growth in demand and output in the period ahead.

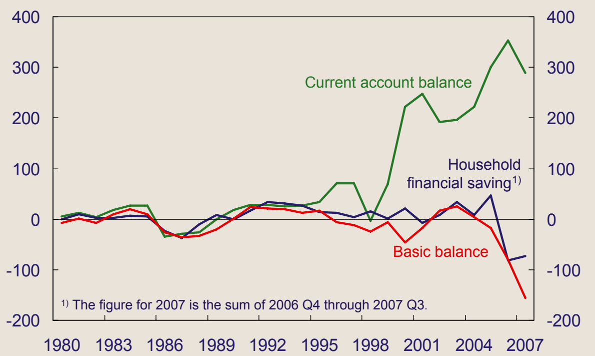
Chart 7 Current account surplus. In billions of USD



Source: IMF

The chart shows changes in long-term interest rates (10 years) and the current account deficit measured as a percentage of GDP between 1980 and 2007. Estimate for 2007.

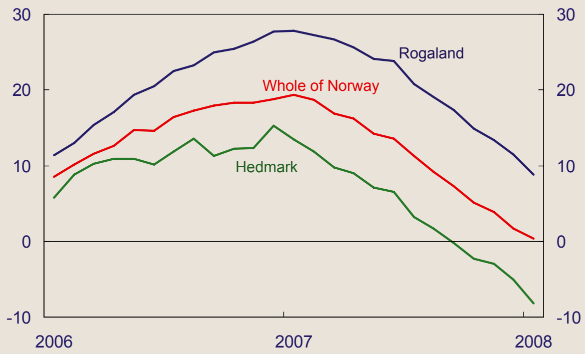
Chart 8 Norway - current account balance, basic balance and household financial saving. In billions of NOK



Sources: Statistics Norway, Ministry of Finance and Norges Bank

The chart shows the current account balance, basic balance and household financial saving between 1980 and 2007. The figures for household financial saving are summed over four quarters up to and including the third quarter of 2007.

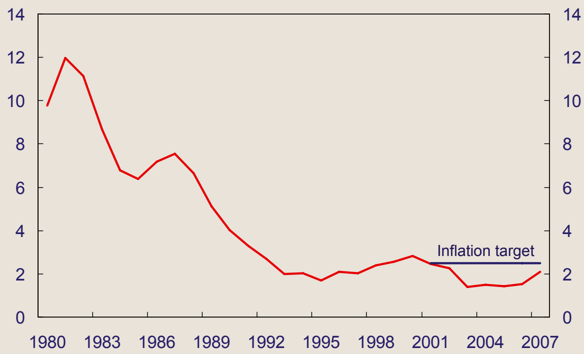
Chart 9 Regional house prices. 12-month rise. Per cent



Sources: Norwegian Association of Real Estate Agents, Association of Real Estate Agency Firms, FINN.no, ECON Pöyry, Statistics Norway and Norges Bank

The chart shows changes in house prices between January 2006 and January 2008. Rogaland and Hedmark are the regions with the respectively highest and lowest house price inflation.

Chart 10 Inflation. CPI. 3-year moving average. Per cent



Sources: Statistics Norway and Norges Bank

The chart shows inflation measured by the consumer price index (CPI) between 1980 and 2007. Annual figures. Three-month moving average is centred.

There are now signs of a cooling housing market throughout the country (Chart 9). House price inflation peaked about a year ago when the housing market was marked by euphoria. Several large residential construction projects are now being shelved.

Should weaker developments in the US lead to a broad-based pause in global growth, there may be various repercussions for the Norwegian economy:

First, a downturn in the world economy may adversely affect activity and profitability in export industries and perhaps even the oil sector. It may be more difficult to sell goods in a falling market, and prices for domestically produced goods may fall.

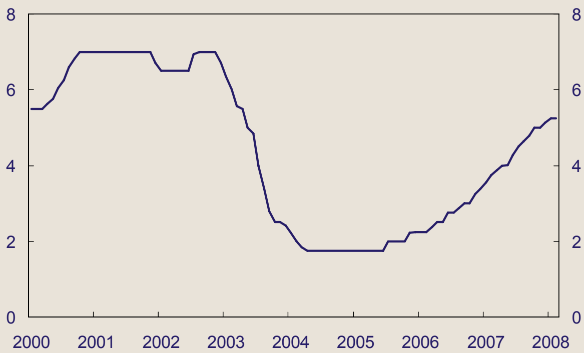
Second, turbulence and weaker growth prospects may increase uncertainty among Norwegian households and businesses. As a result, new projects and investments may be postponed, or enterprises may be reluctant to recruit new employees.

Third, the financial market turbulence has a more direct impact on the business sector. Banks and investors now apply a higher premium and higher prices for providing capital for acquisitions, restructuring and investment, and highly leveraged companies have to pay high loan risk premia.

We still do not know what the full impact of the turbulence will be. The US authorities have taken measures. It remains to be seen whether they will have an impact. At the same time, growth in Norway has been strong and inflation is on the rise.

Monetary policy in Norway is oriented towards keeping inflation low and stable. The operational target is annual consumer price inflation of close to 2.5 per cent over time. The inflation target is an anchor for expectations in the foreign exchange market, the social partners and price-setters in NOK. Buyers and sellers of NOK, businesses and households, price-setters and wage-earners can expect inflation to be close to 2.5 per cent over time.

Chart 11 Norges Bank's key policy rate. Per cent



Source: Norges Bank

The chart shows changes in Norges Bank's key policy rate (sight deposit rate) between January 2000 and February 2008. The figure for February 2008 is estimated as the average for 1–13 February. Monthly figures.

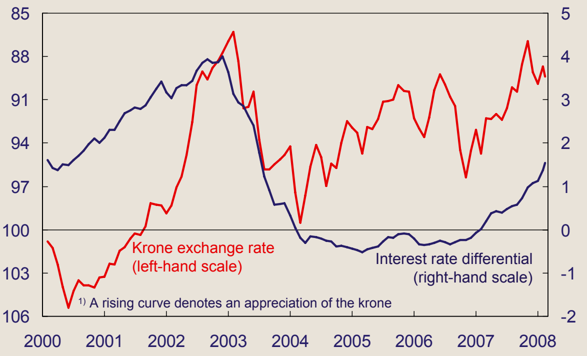
There is a division of responsibility in economic policy:

- Monetary policy steers inflation in the medium and long term and can also contribute to smoothing fluctuations in output and employment.
- The government budget – growth in public spending – influences the real krone exchange rate and the size of the internationally exposed business sector in the long term.
- Wage formation and economic structures and incentives determine how efficiently labour and other economic resources are used.

Even if inflation fluctuates somewhat from one year to the next, inflation has remained fairly close to target over time (Chart 10). Inflation was particularly low in the years around the turn of the millennium when cheap goods flowed from Asia into our country while productivity in the business sector grew sharply. The rise in prices for domestically produced goods and services was also low.

Interest rates were cut in response to lower inflation (Chart 11). Economic agents could then expect inflation

Chart 12 Krone exchange rate and interest rate differential. Index and per cent



Sources: Reuters and Norges Bank

The chart shows changes in the interest rate differential between the Norwegian three-month money market rate (NIBOR) and a weighted average of three-month money market rates among our trading partners. The krone exchange rate is measured by the import-weighted index (I-44). Monthly figures.

In the long run, the krone exchange rate is determined by changes in the terms of trade and permanent differences between domestic and external inflation and productivity. But the krone exchange rate also shows monthly and yearly fluctuations. The krone was strong towards the end of the previous cyclical expansion, but depreciated when interest rates declined in 2003. Thereafter, the krone appreciated again as growth in the Norwegian economy recovered.

Over the past two years, the krone has appreciated by close to 5 per cent. Inflation has nevertheless picked up and is now fairly close to 2½ per cent.[3]

The sizeable basic balance deficit may result in a renewed depreciation of the krone. If the bleak prospects for the world economy translate into lower prices for oil and other export goods, this may also lead to a depreciation of the krone. We have already observed that investors sell NOK in periods of turbulence. If the krone depreciates, the interest rate will then have to be set higher to keep inflation at bay unless a slowdown in activity has a dampening impact on inflation.

to gradually move up to target over time. Growth could also remain high for a period without a rapid rise in inflation. Low interest rates made it possible for us to make use of the potential for higher consumption and investment.

There are now signs that price and wage inflation is on the increase. Higher food and energy prices are fuelling inflation in other countries. Thus, we cannot assume that prices for imported goods will continue to fall. Moreover, domestic productivity does not seem to be improving as quickly as earlier. The rise in prices is therefore likely to quicken for goods and services produced in Norway. Since summer 2005, the key policy rate has gradually been raised again to a more normal level in order to prevent inflation from becoming too high.

As mentioned, external interest rates are again moving down and the interest rate differential against other countries has widened recently (Chart 12). This may lead to a stronger krone, but there are also opposing forces in the foreign exchange market.

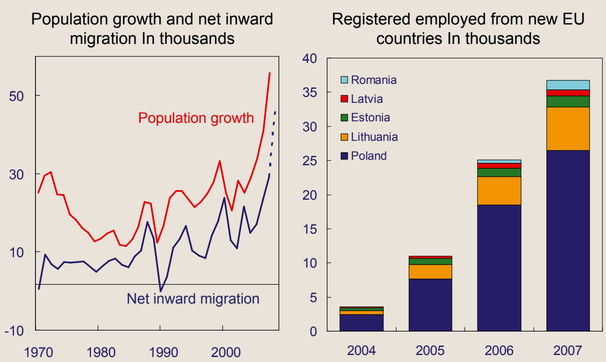
The opening of the labour market to the new EU countries has provided us with access to a reserve of labour. There has been a substantial flow of labour into Norway (Chart 13). Labour migrates to locations where potential earnings are highest. Growing numbers of workers are moving to Norway and establishing residence here. Many workers are only here on short-term assignments and will perhaps move on when the job is done and when there is an economic turnaround.

In 2007, Norway's population increased by about 55 000, with net inward migration coming to 35 000. This is the highest population increase ever registered.

Employment has grown rapidly over the past two years, the highest rate recorded over the past few decades (Chart 14). Even though there has been an ample supply of labour, unemployment is low and the number of job vacancies is record high. The labour market is tight.

High pay increases have often been awarded in the

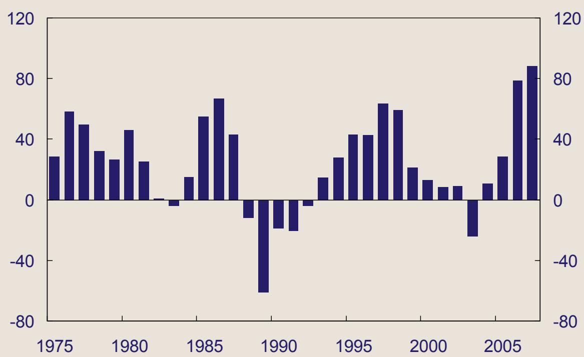
Chart 13 Population growth and workforce migration



Sources: Statistics Norway and the Central Office - Foreign Tax Affairs

The left-hand chart shows population growth and net immigration (in thousands) between 1970 and 2007. Net immigration is estimated. The right-hand chart shows the number of registered employed (in thousands) from new EU countries between 2004 and 2007.

Chart 14 Change in employment. In thousands

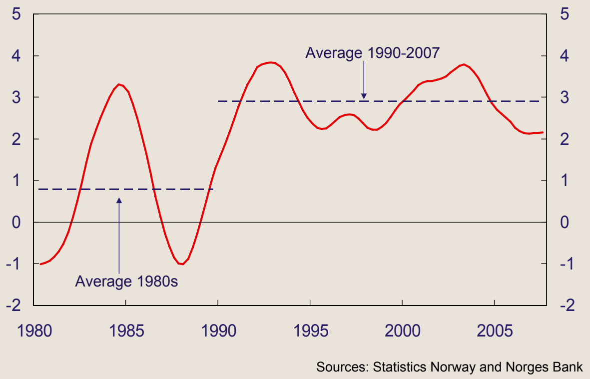


Sources: Statistics Norway and Norges Bank

The chart shows changes in employment based on national accounts figures. Figures for 2007 are estimated based on Monetary Policy Report 3/07.

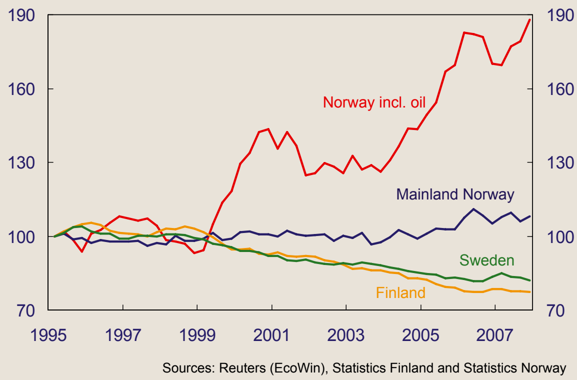
3 Norges Bank uses different measures of underlying inflation. In January, the twelve-month rise in the CPI-ATE was 1.9 per cent; a weighted median showed a rise of 2.4 per cent and a trimmed mean 2.9 per cent. The twelve-month rise in the CPI was 3.7 per cent following a sharp increase in energy prices.

Chart 15 Productivity growth. Per cent



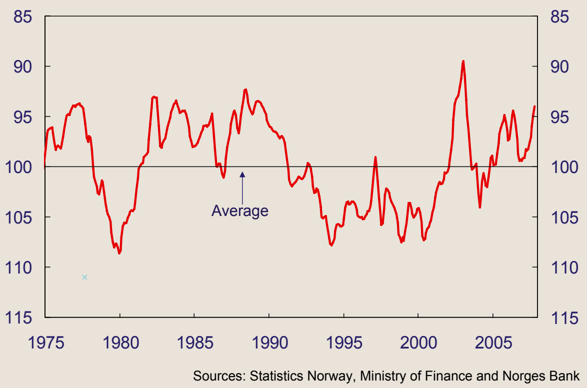
The chart shows trend productivity growth for mainland Norway excluding the public sector, export-oriented manufacturing, electricity and housing services, measured in per cent, between the second quarter of 1980 and the second quarter of 2007.

Chart 16 Terms of trade. Index



The chart shows the terms of trade for Finland, Sweden, Norway and mainland Norway, between the first quarter of 1995 and the fourth quarter of 2007. The terms of trade are estimated as export price index relative to import price index.

Chart 17 Real krone exchange rate. Index. Average 1971–2007 = 100



The chart shows changes in the real krone exchange rate. The real krone exchange rate is defined as the price level in Norway relative to our trading partners, measured in a common currency. An appreciation of the real krone exchange rate may reflect a rise in the price level in Norway relative to our trading partners, an appreciation of the nominal krone exchange rate against other currencies, or a combination of the two. The calculations are based on the consumer price index (CPI). The nominal krone exchange rate used in the calculations is the so-called effective krone exchange rate, which is a trade-weighted exchange rate for Norway. The average is estimated over the period 1971–2007.

late phase of an expansion, and been followed by rising inflation. Employees and businesses have at times looked backwards – and may not recognise that the outlook has changed – when determining wages and conditions that influence employment and profitability. This was the case in 1974 and 1975 and again in 1986 and 1987. It was the case in 1998 and also in 2002. In each case, the result was high interest rates, stagnating production and rising unemployment.

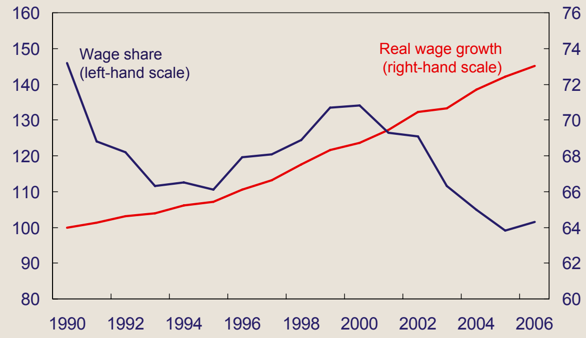
Should the recent sharp rise in employment result in unexpectedly high wage growth, the interest rate will again have to be set at a high level to keep inflation subdued. We may again experience a high interest rate level in Norway relative to other countries over a longer period. This could translate into a pronounced setback in production and employment.

The Norwegian business sector has become increasingly efficient (Chart 15), inducing companies to increase their workforces. During the recovery after the turn of the millennium, productivity growth jumped up again. This resulted in strong growth and low inflation.

Rising imports from low-cost countries and high prices for many of our export goods resulted in a substantial improvement in Norway's terms of trade from the end of the 1990s (Chart 16). Norway's situation differs from that of our neighbouring Nordic countries in that both Sweden and Finland have recorded a deterioration in their terms of trade. They sell large volumes of high-tech products but at falling prices. Productivity and terms-of-trade gains have provided the Norwegian economy with a historically strong income boost. National income increased by a little more than 30 per cent in real terms between 2003 and 2007.

The real krone exchange rate (Chart 17) measures developments in the value of the Norwegian krone, adjusting for inflation differentials between Norway and its trading partners. This provides an indication of the relationship between the level of external and domestic prices, which in turn reflects developments in cost levels. In real terms, the krone has appreciated by about 10 per cent since the mid-1990s, while labour costs in a common currency have risen by close to 30 per cent more than among our trading partners. This may be partly ascribable to the cyclical expansion and the low level of household saving. But most likely the strong krone reflects the substantial improvement in the terms of trade and productivity. Public spending growth is fuelling demand for goods and services and draining labour from the business sector, albeit not faster than planned. Even though the cost level in Norway has increased and is high, there is full employment. Thus, it seems that our business sector will have to live with – and can live with – the real value of the krone and the current cost level unless a possible downturn has a particularly severe impact on the Norwegian economy.

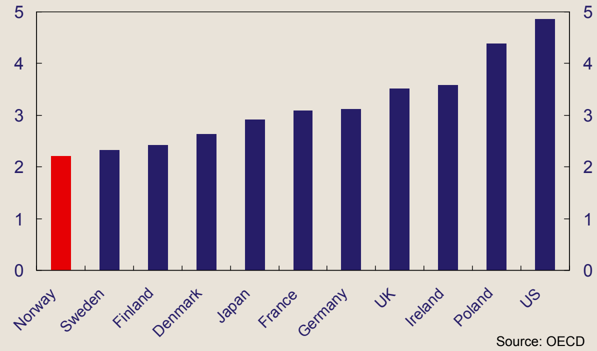
Chart 18 Real wage growth and wage share. Index and per cent



Sources: Statistics Norway and the Technical Reporting Committee on Income Settlements

The chart shows changes in real wage growth and wage shares. Real wages are defined as wages per normal person-year adjusted for annual nominal consumer price inflation (CPI). Average for all industries. 1990=100.

Chart 19 Wage differential in OECD countries in 2005. Ninth decile/first decile



Source: OECD

The chart shows average pay in the ninth decile and the first decile in the wage distribution. The figures comprise wages for full-year, full-time employees.

Sharing the benefits

There was a fundamental shift in Norwegian economic policy in the 1980s and 1990s.[4] Capital and credit markets were liberalised. It became easier to establish and build up new businesses. The EEA and WTO agreements resulted in stronger competition and increased flows of goods and services, labour and capital. As a result of the 1992 tax reform, the welfare state could be funded with reduced impact on wealth creation. The framework conditions for the electricity market, telecom market, aviation and broadcasting were changed. Trade was liberalised. State-owned companies were listed on the stock exchange and new forms of managing public agencies were developed. Industrial policy no longer kept unprofitable enterprises afloat. And last but not least, in Norway as in other countries, norm-based or rule-based monetary and fiscal policy was introduced.

The shift gave a boost to the economy, but in recent years it has been accompanied by a change in the distribution of income between labour and capital. This is probably a result of structural changes in the global economy. A rising share of the global production of goods and services is moving across the Pacific. Cheap Asian labour has changed industry structures and trading patterns in many Western countries, including Norway.

New producer countries are fuelling competition, but are also creating new markets and producing cheap consumer goods. There has been a sustained rise in employment and wealth creation in the West. China, India and other emerging economies have doubled the supply of labour on the global market.[5] This has helped paved the way for strong growth, but has also curbed wages in many occupations in a number of industrialised countries.

Norwegian households have enjoyed lower prices and a broader range of goods. It has been easy to find employment. Norwegian owners and shareholders have also fared very well.

Although the share of value added accruing to wage earners has decreased since the beginning of the 1990s, real wage growth has been high (Chart 18). On average, today's wage earners earn real wages that are 50 per cent higher than in 1990. This corresponds to annual growth of over 2 per cent. At the same time, employment has risen.

Business and labour market conditions have been unusually favourable in recent years. Should export prices fall, productivity growth slacken and foreign workers return to their home country, the wage share and unemployment will increase and business sector profits will fall. Even in the absence of these developments, low unemployment and high profits may be difficult to sustain. Developments will depend on how far businesses – in their search for qualified labour – will bid up wages.

The economic policy reforms of the 1980s and 1990s set the stage for invention and innovation and the development of a market for equity capital and loans in Norway. This has resulted in restructuring in the business sector, increased productivity, real wage growth and a high level of job creation, but also very high earnings for successful businesspeople and entrepreneurs. We will probably have to learn to live with our entrepreneurs and capital owners, and they must live with the society that has provided them with favourable business conditions.

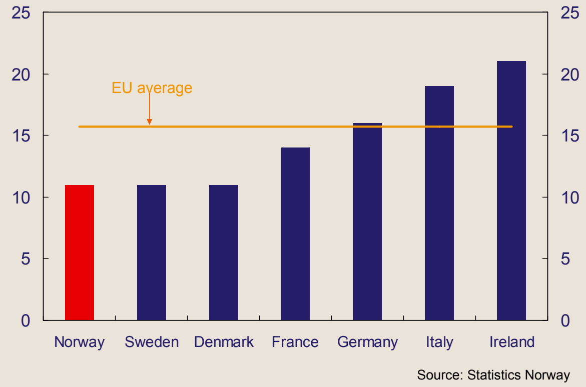
In Norway, there is a relatively even distribution of income, as illustrated in Chart 19. In the chart, we compare the second-highest decile of wage earners with the lowest decile. Wage differentials are smaller in Norway than in any other OECD country. In the US, the group of wage earners in the second highest decile earn almost five times as much as the lowest decile while in Norway that group only earns twice as much.

Thus, the fundamental shift in economic policy and sharp income growth in Norway have not resulted in substantial wage disparities.

4 From Jon E. Dølvik, T. Fløtten, G. Hernes and J.M. Hippe (2007): "Hamskifte – Den norske modellen i endring". (Fundamental shift – the Norwegian model in flux), p.15, Gyldendal Norsk Forlag A/S. Norwegian only.

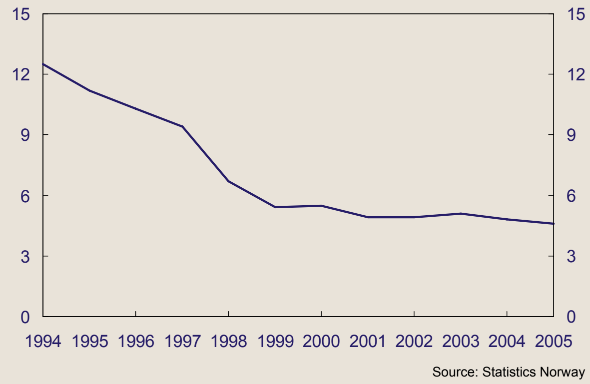
5 Richard B. Freeman: "Labor Market Imbalances: Shortages, or Surpluses, or Fish Stories?" at the Boston Federal Reserve Economic Conference, June 14–16, 2006.

Chart 20 Share of persons with low income. Per cent



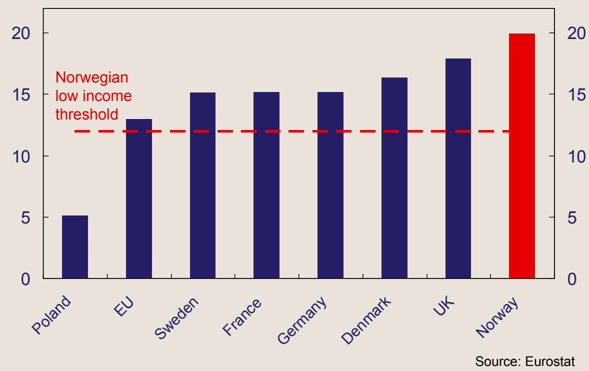
The chart shows the number of persons with low income as a percentage of the population. The concept of low income is based on the EU definition (60% of national median income, less social benefit transfers).

Chart 22 Share of persons in Norway with low income. 1994 threshold. Per cent



The chart shows changes in the share of persons with annual low income as a percentage of the population. Low income is based on income thresholds for 1994 and adjusted for CPI inflation.

Chart 21 Income in selected countries in 2006. Adjusted for purchasing power. In thousands of EUR



The chart shows median income after tax adjusted for purchasing power in selected European countries in 2006. Figures in EUR.

When the EU assesses income distribution, low income is defined as less than 60 per cent of median income[6]. Compared with other European countries, the low-income group is small in Norway and the other Nordic countries (Chart 20). In Norway, 11 per cent of the population is defined as low-income earners, while the average for the EU is a good 15 per cent. In addition, the Nordic countries provide a high level of government-financed welfare services.

Analyses of low income do not take into account that income levels in Norway are very high. The threshold for low income in Norway is shown by the line in Chart 21. It is almost as high as median income in the EU, and not that far from the level in Sweden.

Nor does the EU definition of low income capture the considerable rise in median income in Norway over the past 15 years. In relation to the 1994 low income threshold, measured in real terms, the low income group has decreased by more than half, falling particularly sharply in the 1990s when unemployment also exhibited a sharp decline (Chart 22).

In addition, turnover is high in the low income group. Around a fourth of the group comprises those aged 16–24, while one fifth are aged 64 and over. Many of those with low incomes are students or old age pensioners.

Thus, low income only becomes a social problem when people remain economically inactive for much of their lives. Both labour market developments and short-term financial incentives can lead to this kind of social exclusion. Social security schemes can also over time become poverty traps, locking in many people who would have been unemployed for a period in other countries. A cause for particular concern is the rising number of young people that receive benefits on a permanent basis.

I will now turn from today's income distribution across groups to the distribution across generations in Norway.

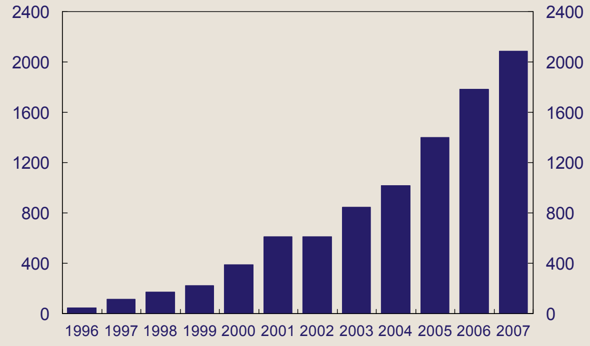
The Norwegian national insurance scheme is a pay-as-you-go system. This means that a given year's pension payments from the scheme are covered by government budget revenues that year. When the national insurance scheme was introduced in 1967, a fund was established to provide for an expected reduction in private saving. However, pensions were still included in the central government budget at an early stage and financed by current tax revenues. Transfers to the National Insurance Fund were soon discontinued.

Nevertheless, confidence in the pension system has actually remained intact, reflected in a low level of household saving, primarily through home investment. Perhaps there is some element of miscalculation here. A fall in value may occur if many homeowners free up housing capital to cushion old age.

It was only when transfers to the Petroleum Fund were introduced in 1996 that funds were accumulated that could also be used to cover future pension payments. The Fund, which has later changed its name to the Government Pension Fund – Global, has grown to well over NOK 2000 billion (Chart 23). Its rapid growth

6 Median income is the income level at the middle point of the income distribution.

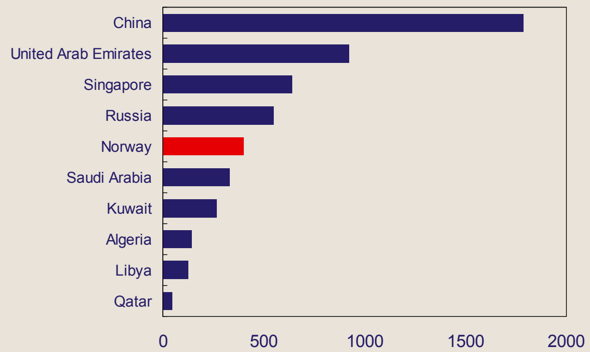
Chart 23 Government Pension Fund – Global. In billions of NOK



Source: Norges Bank

The chart shows the market value of the Government Pension Fund – Global at end-year. The figure for 2007 is the market value at 30 November 2007.

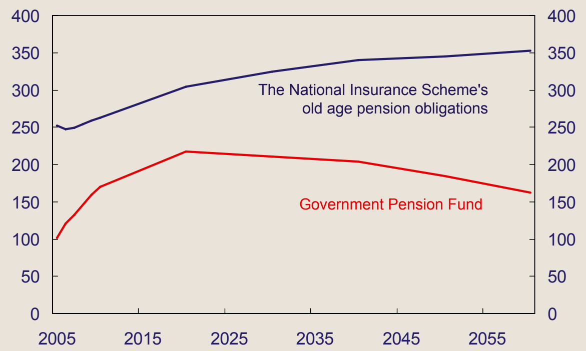
Chart 25 Large sovereign-wealth funds and foreign exchange reserves. In billions of USD



Sources: Morgan Stanley Research and IMF

The chart shows a selection of large sovereign wealth funds and foreign exchange reserves, measured in USD billions. Figures for September 2007.

Chart 24 Pension obligations and the Government Pension Fund. Per cent of mainland GDP



Source: Norges Bank

The chart shows estimates for the National Insurance Scheme's old age pension obligations and the Government Pension Fund as a percentage of GDP for mainland Norway.

was neither expected nor planned and was due to the abrupt improvement in government finances during the economic upturn in the 1990s. After the turn of the millennium, the rise in oil prices also provided a boost.

The size of the Fund is now equivalent to approximately one year's GDP and may double in the next five to ten years. Total public expenditure is equivalent to less than half of total GDP. If the government spends 4 per cent of the Fund annually – the expected real return – this will finance close to 20 per cent of public expenditure ten years ahead. The return on the Fund will by then have become such an important source of funding that it is difficult to imagine that the government authorities would find any sound arguments for drawing on the accumulated capital. It is also a flow of revenues that does not have an adverse effect on private sector production capacity, unlike taxes.

Irrespective, only a share of future pension payments will be matched by revenues from the Government Pension Fund (Chart 24). Government old-age pension obligations are estimated to increase from around 250 per cent of mainland GDP today to approximately 350 per cent in the course of a few decades. As a result of the pension reform, the increase will be somewhat smaller.

As a major shareowner and bondholder, Norway has received increasing international attention. Many countries have established funds similar to the Government Pension Fund – Global, with substantial assets under management (Chart 25).

We are open about the Fund's objectives, organisation and investments. This is necessary in Norway because the funds are public funds and because transparency enhances management. Moreover, the transparency of the Fund is also viewed in a favourable light by those countries in which we invest. Internationally, the Government Pension Fund – Global is therefore often cited as a best practice fund. But perhaps we should add that the transparency competition between funds could be enhanced.

The underlying motivation of these investors and whether the investments may be politically motivated have been called into question. Some fear strategic acquisitions of companies that are of considerable national importance. There have been calls for these funds' investments to be monitored closely.

The management of the Fund is based on two ethical commitments:

First, there is the consideration relating to future generations. The Fund must ensure high capital returns at a moderate risk, by means of professional management with effective control of operational risk.

Second, the Fund must respect the fundamental rights of those affected by the companies in which the Fund has invested. The instruments used here are the exclusion of companies from the Fund's investment universe and the active exercise of ownership rights.

The Ministry of Finance excludes companies that produce certain types of weapons. They also exclude companies when they identify an unacceptable risk of contributing to gross corruption, severe environmental degradation, and serious violations of human rights and of fundamental ethical norms. Norges Bank exercises its ownership rights by voting at general meetings and through direct contact with companies. Moreover, priority is given to combating child labour and we look critically at how companies influence the authorities in environmental issues.

Over time, engaging in dialogue with companies is probably a more constructive approach than exclusion. Irrespective, perseverance and patience are required if we are to achieve results. We should not allow the management of the Fund to be ruled by the impulsive and changing priorities that beleaguer so many public programmes and sectors.

When we invest the Pension Fund's assets, we are guests in our neighbour's house. The requirements for the exercise of ownership rights cannot therefore be based solely on Norway's values and culture. We must acknowledge that the dividing lines between politics, ethics and management may be different in other countries. When we point a finger at a company, we are also pointing a finger at the laws, regulations and practices of countries where the company is based and operates – and we are pointing that finger as a representative of the Norwegian state.

Conclusion

When other countries look at Norway, they may agree with another Norwegian poet whose 100th anniversary we are celebrating this year, Olav H. Hauge, when he wrote that "self-esteem grows with the size of your bank account".[7]

We have enjoyed great economic prosperity over the past 10–15 years. But perhaps a warning can be found in one of Hauge's poems. Allow me to recite:

"Too happy by half –
the pot's boiling over,
the scale arm is pointing sky-high!
I must do something contrary,
throw cold water on the pot,
hang a stone on the scales,
fell the biggest pine I've got" [8]

Thank you for your attention!

[7] Text from Olav H. Hauge (2002): "Lagnaden gjer mange til heltar. Aforsimar i utval", Det Norske Samlaget. Translated by Helle Snellingen and Veronica Harrington, staff translators, Norges Bank.

[8] From Olav H. Hauge (1988): "Mange års røynsle med pil og boge – 99 dikt av Olav H. Hauge", Det Norske Samlaget. Translated by Helle Snellingen and Veronica Harrington, staff translators, Norges Bank.