Economic Perspectives

Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 15 February 1990

At the start of a new decade it is natural to look back and consider what lessons may be learned from the decade behind us. The international economy has fared better than we feared earlier in the 'eighties, and we shall take a closer look at how both our own and other countries' experiences can be turned to account in the period ahead.

In a broader political perspective we have a strong feeling that the turn of the decade marks the start of a new epoch. However, I shall, in this address, abstain from reviewing the European scene, both with respect to changing market conditions and the revolutionary political developments. Rather I will focus on matters more within our own realm, e.g. Norway's labour market situation, which at the start of the new decade is no longer very different from that prevailing in many West European countries. I hope to contribute to a clearer understanding of how difficult it is to solve these problems, even when sights are set lower in this respect than we have seen fit to accept up to now. This does not mean there is no solution. On the contrary, I shall point to some areas in which a solution must be sought.

Since the end of 1986 we have pursued a monetary policy which initially caused interest rates to rise, subsequently to fall, and — since the summer — to rise anew. Now, having gone through all the phases, is a good point at which to review the basis for this policy, and our experiences.

In the 1980s the increase in government lending contributed to financing purchases of goods and services by the rest of the economy. Now, at the start of the 1990s, a turnaround is under way. New perspectives are emerging on which a stance must be adopted, not least on issues in the domain of the central bank.

I shall close with some reflections on countercyclical and structural policies, freedom of action and norms.

Better than expected in industrialised countries

The international economic upswing is in its eighth successive year. In the light of historical experience this is quite a long period, and predictions of its collapse have been rife. However, there are still many positive features to indicate that the upswing may well persist for some time yet.

— Previous periods of expansion have often been interrupted by measures to counter inflation. This time there appears to be a wider perception that inflation has been brought under control, which in itself is curbing cost growth. Furthermore, the monetary authorities in the major economies appear to be prepared to respond rapidly to signs of quickening inflation.

- The primus motor of the upswing is now investment, designed to expand capacity rather than replace costly manpower. This will reduce the risk of bottlenecks and the consequent pressure on prices, enabling unemployment to be gradually reduced.

- The process leading to the establishment of the EC internal market already appears to have stimulated activity levels, and the opening of frontiers towards Eastern Europe can be expected to have a similar impact. Moreover, a reorganisation of the economic systems of these countries implies enormous potential for economic advancement; however, the extent of transitional problems faced by these countries, and what setbacks they will meet on the path to economic development, remain uncertain.

On the other hand, there are plenty of negative factors to counterbalance the positive ones. No solution to the imbalance in international payment flows is in sight. Inflation remains at a level which there is no good reason to accept. And the heavily indebted developing countries are experiencing little of the developed countries' economic growth. Nor should we forget that the rate of economic growth, gratifying as it is, is nonetheless moderate compared with the period prior to the first oil price shock — but, in a longer-term perspective, it may rather be this period which was exceptional.

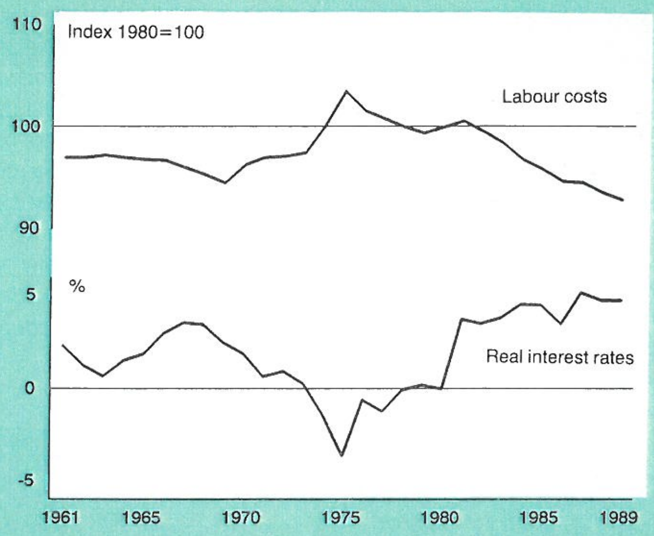
Even so, by and large the balance between positive and negative factors in the forthcoming period appears to lean more in favour of the former than has usually been the case. Let us therefore look to the past for any widely observable features in the relatively successful period of adjustment which the industrialized countries underwent in the 1980s. Norway was in a position to postpone adjustment for some time thanks to rising petroleum earnings. In the past three or four years Norway too has had to embark on this process, but such is the leeway to be made up that we can still benefit from other countries' experiences.

Towards the end of the 1970s, policy in many countries was re-oriented towards putting the emphasis on long-term objectives. Preceding years' combination of inflation, setbacks and external deficits had weakened the belief that it was possible to fine-tune the economy. The priority now was to bring down inflation and thus also inflationary expectations. In the initial phase the brunt was borne by monetary policy. Subsequently fiscal policy was strengthened, serving the same purpose. This process is partly a result of the upswing itself, but also of marked restraint in public spending. Several countries, not least our closest neighbours, have in a short space of time carried out impressive budget policy reforms.

The new policy approach led to a marked increase in real interest rates, due both to a higher nominal interest rate level and slower inflation. It also led to a substantial rise in unemployment and to a slowdown in growth of real wages to the point where they rose less than productivity. The relationship between capital and labour costs thus shifted in favour of labour. Demand for labour has consequently edged upwards, and in recent years the level of unemployment in Europe has finally begun to decline. The trend in productivity and wages has also resulted in improved profits, which is a prerequisite for the increase in investment which I have already mentioned.

More or less concurrently with this readjustment of macropolicy, structural

Chart 1.
Labour and capital costs in the EC, 1961-89



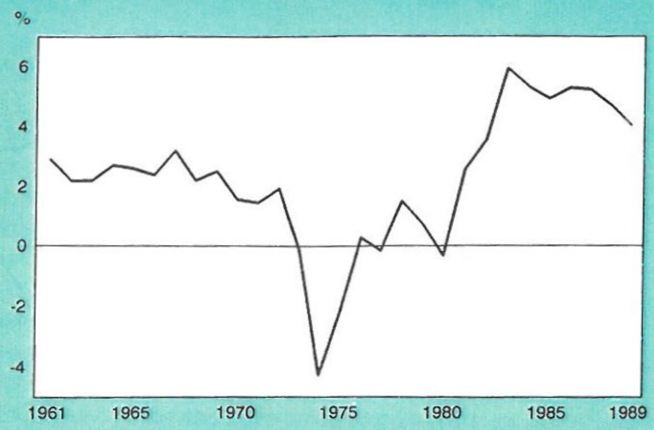
Real unit labour costs increased in the 1970s, whereas the real cost of capital — measured here by long-term real interest rates - fell. This led to lower profits in business and industry and reduced investment, while such investment as was carried out was largely designed to replace costly labour with cheaper capital. After a time unemployment rose sharply. In the 80s this shift in the relative price of capital and labour was reversed. The result: higher profits, increased investment, stronger growth and reduced unemployment.

Source: EC Commission

policy started to receive greater emphasis, notably through measures designed to increase competition and promote a more appropriate regulatory framework. The ongoing GATT negotiations and the EC internal market are examples of the former, while the tax reforms which many countries have introduced or are working on are examples of the latter. The tax reforms go generally in the direction of broader tax bases and lower marginal tax rates. Although distributional gains are a common spin-off, the objective of the reforms is rather to improve efficiency.

Nonetheless, much remains to be done in the area of structural policy. A prolonged struggle must be maintained against new trade barriers. The industrialised countries' agricultural policies have a price-raising effect for these countries and deny market access to goods produced by developing countries. In the labour market the wage formation mechanism is inflexible throughout and raises barriers to less competitive labour. Yet even in these areas the trend is stronger market orientation, albeit in the face of opposition from the established interest groups.

Chart 2.
Long-term real interest rates in the OECD countries, 1961-89



Real interest rates fell sharply in the 1970s, and at times were negative. Higher inflation in the wake of the oil price increases was not matched by an increase in nominal interest rates. At the beginning of the 80s policy was tightened. Nominal interest rates rose, and price inflation diminished. Both factors contributed to a sharp increase in real interest rates, which subsequently settled at a high level. Real interest rates are measured here by nominal long-term government bond rates deflated by the consumer price index. Not all OECD countries are included owing to absence of data. Included countries represent a good 90 per cent of aggregate GDP of the OECD.
Source: OECD

A confidence-building policy

In addition to yielding visible results, policy has influenced expectations. Both wage-earners and enterprises have greater confidence in price stability. In Western Europe it is not expected that exchange rates will be used to regain competitiveness, and a reasonable degree of stability is also expected among the major international currencies. In money and capital markets this confidence shows in the relative stability of long rates in the face of fairly steep rises in short rates. Markets have had faith in the ability of the monetary authorities to master inflation, although recently there have been disturbing signs that this confidence may be faltering.

Belief in stability appears to be more important for the economic climate than demand-management measures. Although knowledge of what determines investment behaviour is imperfect, the interest rate level is widely considered an important factor. Hence, it is worth noting that the investment boom of recent years occurred in the face of an historically high level of real interest rates. Moreover, private consumption has increased despite a tightening of fiscal policy and a high interest rate level.

We must take care not to make the mistake of replacing a set of uncertain explanatory factors with a new set which is capable of explaining many conditions by virtue of its vagueness. If we accept the importance of confidence, the task remains of transforming this acceptance into a policy which which will withstand currently unforeseeable strains on the economy. A new and rapid rise in oil prices or a new stock exchange crash could easily require measures of a more short-term nature on the part of the authorities. Nonetheless, in the sphere of international economic policy and cooperation among countries which has evolved in this area, there is a tendency to tone down countercyclical policy in favour of longer-term stability. Indeed, this shift in emphasis appears so far to have smoothed cyclical fluctuations. Although of course we have no guarantee, the revision of economic thinking could well be sufficiently fundamental to enable the economy to withstand cyclical conditions less favourable than those witnessed through most of the 1980s. This gives grounds for a cautiously optimistic outlook for the international economy on the threshold of the 1990s.

Surplus and unemployment

In the domestic arena the year behind us added two new features to the economic picture:

— The external deficit turned into a surplus, and

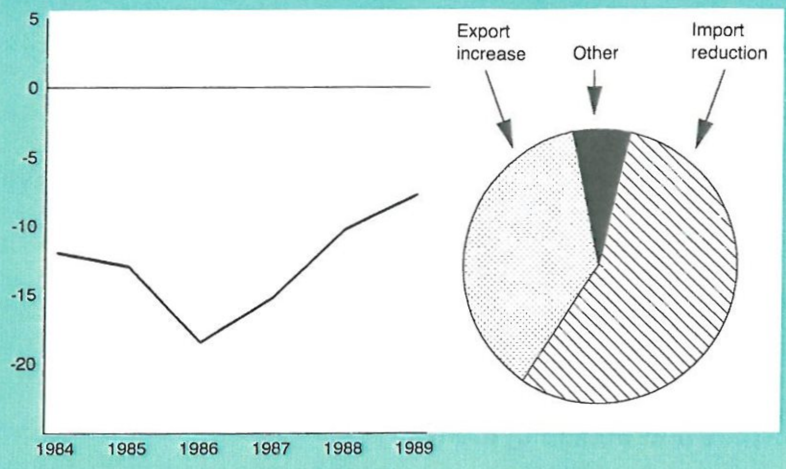
— unemployment reached an unprecedented high level.

After the record deficit of 1986 a fairly strong turnaround was inevitable, since domestic demand had reached a level from which it could do nothing but fall — even in the absence of retrenchment measures. We may therefore obtain a more realistic picture if we take as a basis the final year in which demand was more or less on trend, viz 1984. Even then there is a palpable improvement in the external economy up to 1989, with a strengthening in the current balance (excluding oil and ships) of over 4 per cent of the gross domestic product, the bulk of which refers to a slowing down of imports. This would have almost brought us back to balance, excluding ships, in 1989, even if the value of oil and gas exports had been as low as in the previous year. However, it was the increase in oil exports in that year which took us beyond balance and into a surplus.

Such a strengthening of the external economy in the short-term could not have been achieved without curbing domestic demand. This is required primarily to reduce imports, but also to make more of our output available for export. Fortunately, international demand was on a sound upward trend when policy was tightened, which has undoubtedly been to our advantage. Seen in this light, the increase in exports is not that remarkable. In recent years we have barely managed to maintain our market shares, and have failed to exploit the high capacity utilisation abroad to increase them. On the other hand, in view of the persistent weakening of our relative cost level right up to last year, more was hardly to be expected.

The increase in exports did not add to employment, and the fall in domestic demand naturally also affected domestic production. Thus it was inevitable that a strengthening of the external economy should be followed by an increase in unemployment. The reduction in working hours in 1987 delayed the process, but once it got under way unemployment rose steeply from the

Chart 3.
Current account excl. oil and shipping as a share of GDP, 1984-89



In the period 1984—1989 as a whole, Norway's current account deficit apart from oil and shipping as a share of GDP fell by 4.3 percentage points. In the first half of the period the deficit grew sharply, but this was more than offset from 1986 onwards. The pie diagram shows how the improvement for the period as a can be decomposed into reduced imports and increased exports of traditional goods and other factors. The decline in domestic demand has reduced imports while high international growth and favourable export prices have led to increased exports.

Source: Norges Bank

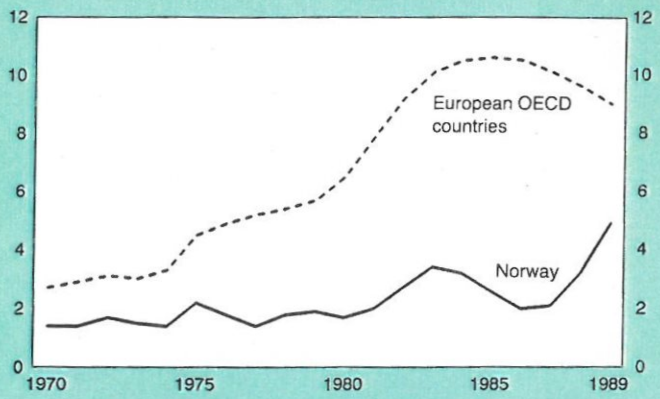
autumn of 1988 up to the new and higher level at which it now appears to have stabilised.

This was understandably a bolt from the blue for many people. Compared with the rest of Europe, unemployment in Norway has been remarkably low. Many other countries registered an unemployment rate of more than 10 per cent; for us the figure was a gratifying 2 per cent or so of the total labour force. The perception gradually spread in Norway that we were able to avoid this high level of unemployment because we were better at organising ourselves than other countries, and because we had different priorities: we put up with the odd bout of inflation provided we managed to keep out unemployment.

Depleting our wealth

However, the real explanation was different. It is well known that a high level of demand can be maintained by allowing spending to exceed earnings. This is true of both households and nations. But it is equally well known that this only works for a time. Debt cannot simply be allowed to grow indefinitely. One will soon have to adjust expenditures, now including the burden of debt service, to current income. This is painfully true for both households and nations.

Chart 4.
Unemployment in Norway and European OECD countries, 1970-89. Percentage of total labour force



Compared with the rest of Europe, unemployment in Norway has long been remarkably low. In 1986, when the difference was at its widest, the figure for European OECD countries was 10.5 per cent, compared with 2 per cent for Norway, according to the Labour Force Survey of the Central Bureau of Statistics. The weakening of the labour market in 1988 and 1989 has taken unemployment in Norway up to 4.9 per cent. Concurrently, the favourable trend in European OECD countries has reduced unemployment by a little over 1 percentage point to 9 per cent.

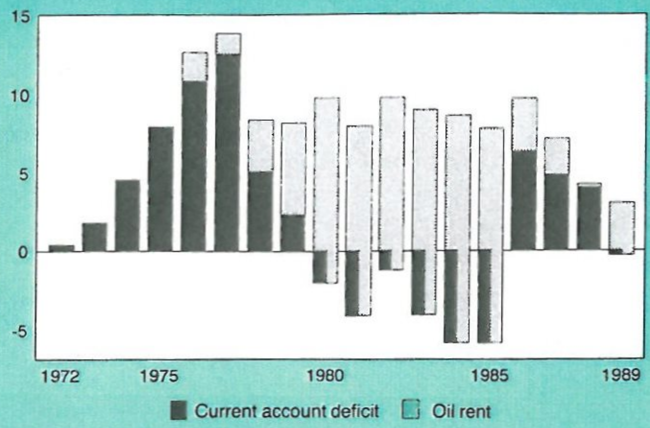
Source: OECD and the Central Bureau of Statistics.

If at the outset there are reserves to draw on, one can carry on a little longer but, even then, spending more than one earns is no lasting solution.

For Norway, the presence of latent wealth in the form of non-renewable energy reserves is especially important. Most non-renewable natural resources obtain a price more or less in accordance with what it costs to extract them. Oil and gas are in a special position since market conditions are such that prices are kept higher than the cost of labour and capital alone would indicate. The Central Bureau of Statistics calls this part of the value the «oil rent». It represents a part of Norway's wealth and we can draw on it to purchase goods and services in excess of those needed to extract oil and gas. We are uncertain of the magnitude of the oil rent, but when we use it we are denying its availability to future generations. We are depleting the nation's wealth.

The sum of net foreign borrowing and oil rent, in the event oil rent less net increase in foreign assets, is a form of wealth depletion. Of course, drawings on this particular form of wealth can be used to finance a build-up of fixed capital, which is another form of wealth. Chart 5 shows what proportion of our use of goods and services has been financed by depleting the nation's wealth over the past 20 years.

Chart 5.
Wealth depletion in per cent of domestic demand, 1972-89



From the mid-1970s onwards, demand in Norway was maintained by depleting the nation's wealth. For Norway it is particularly important that her non-renewable energy resources, oil and gas, have given a return over and above the ordinary cost of labour and capital — the oil rent. Wealth depletion is defined here as the sum of oil rent and net borrowing abroad (current deficit). In the period 1976-87, wealth depletion constituted on average 9½ per cent of domestic demand. In the first half of the 1980s and in 1989, wealth depletion was lower than the oil rent owing to Norway's current account surplus.

Source: Norges Bank

The chart shows that 8-10 per cent of our domestic demand came to be financed in this way. It enabled us to maintain a high level of activity and avoid the unemployment experienced by other countries. In the second half of the 1970s it entailed the depletion of a steadily increasing share of our national wealth, mainly in the form of borrowing abroad. When we attempted to curb the process, unemployment gradually rose early in the 1980s. Our response was to allow a renewed increase in wealth depletion, which incidentally was in excess of what full employment would require, resulting in intensified wages and price pressures.

The dramatic shortfall in the oil rent caused by the collapse of oil prices at around the end of 1985 could not be compensated for by borrowing abroad. Hence the rate of wealth depletion had to be reduced in just a few years; it is now less than half the figure for the 1980s. Because the high level of employment was based on wealth depletion as a continuing option, employment was inevitably affected when the depletion rate was cut back.

For many, unemployment co-existing with so many unsolved national tasks is a paradox. The explanation lies in what I have just pointed out. At the level of income generated by full employment, the demand for imports cannot be met without reaching fairly deep into our oil wealth and paying out of that.

The structure of the Norwegian economy has adapted to the depletion option to the point where full employment is now incompatible with the external balance required by long-term considerations.

This is not to say that the increase in domestic demand which may be expected in the period ahead will not result in some improvement in the labour market situation. Even if this increase in demand should entail some degree of continued wealth depletion, we will most likely be able to endure it. But we know from experience what an unreliable option this is, and we also know that oil output will peak in the 1990s and thereafter slowly decline. Thus it is crucial that our first step should be to stabilise the rate of wealth depletion before moving progressively towards eliminating our reliance on it. With reasonably good prices, we should be able to achieve the surpluses on the external account needed to repay our net foreign debt before petroleum output starts to decline. The proposed petroleum fund could be of help here, provided it is geared to this long-term priority.

An important objection to using the option of wealth depletion to balance our economy is that the burden of the social security system on the economy will increase just at the time when the oil rent is expected to show its sharpest decline.

High employment requires structural policy

Basing employment policy on growth in domestic demand is synonymous with increased wealth depletion. If we rule out this option, employment policy must be based on changing the structure of the Norwegian economy with a view to increasing market shares, both in export and import markets.

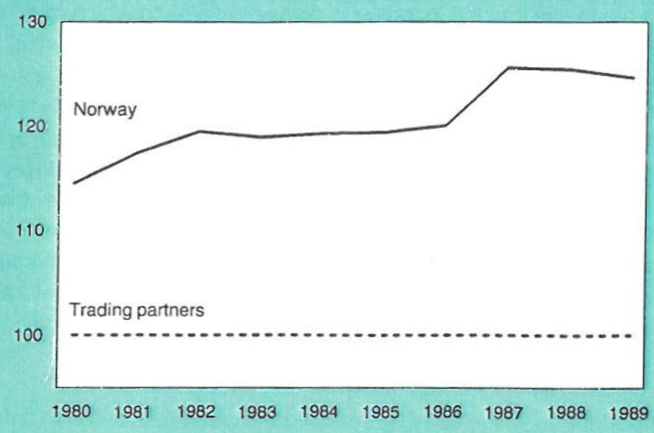
Setting the stage for renewed growth in this way necessarily requires more time than generating growth through increased demand. Nevertheless, the lesson from other countries is that the path to new growth is through structural policy. I have already referred to a number of features common to the international economy:

- market-oriented conditions for competition
- neutral tax rules
- low inflation
- policy geared to long-term stability

Although the size of the public sector and direct and indirect tax rates form part of the framework of structural policy, the elements of this policy are only partly formulated through the fiscal and national budgets. The many economic policy decisions adopted during the year, and their effects in areas other than those on which the decisions have a direct bearing, are equally important. Above all, it must be realised that structural policy is not a policy concerned with devising a structure, for instance by finding new growth areas for Norwegian business and industry. Structure is determined by market participants' choices as influenced by the regulatory framework.

This is not the place to examine all the elements of a structural policy. I shall concentrate on the two most important factors of production: labour and capital, and the costs associated with their application.

Chart 6.
Unit labour costs in Norwegian manufacturing industry, 1980-89. Trading partners = 100



Total hourly labour costs for adult workers in Norwegian manufacturing industry are about 25 per cent higher than among our trading partners (measured in common currency). Moreover, average annual productivity growth has been a little over 1 per cent lower since 1970. In 1989, for the first time since 1980, hourly labour costs, in terms of national currency, grew less in Norway than among our trading partners. At the same time, the shedding of jobs in manufacturing industry led to strong productivity growth. Norway's competitiveness in terms of relative unit labour costs thus apears to have improved by 4 per cent in 1989.

Source: Central Bureau of Statistics and Norges Bank

Wage formation lies essentially outside the authorities' domain; yet remuneration is by far the most important component of costs and of our incomes. Wage behaviour is thus a fairly crucial element that cannot be ignored. The fact that we are approaching a round of collective wage negotiations that is of crucial importance for the 1990s gives this issue added focus and actuality.

The initial position with respect to wage costs is not encouraging. In manufacturing industry — which counts most in the international exchange of commodities — wage costs exceed the average for our trading partners by all of 25 per cent. There is no reason to believe that this is matched by higher productivity in Norwegian industry than abroad. On the contrary, in the 1970s and 1980s Norwegian manufacturing recorded a productivity growth rate averaging 1 per cent less per year than the rate among our trading partners.

The part of our economy exposed to international competition is dominated to a disturbing degree by oil activities and commodity-based industry with limited growth potential. Expansion must be in the form of «new» activity offering the possibility of lasting, profitable employment: it must not be the result of government-subsidised inputs — be they capital, hydroelectric power or labour. In this area too the task of the authorities is to ensure that the framework is as appropriate as we can possibly make it, and that means that prices of inputs must reflect their value in alternative applications.

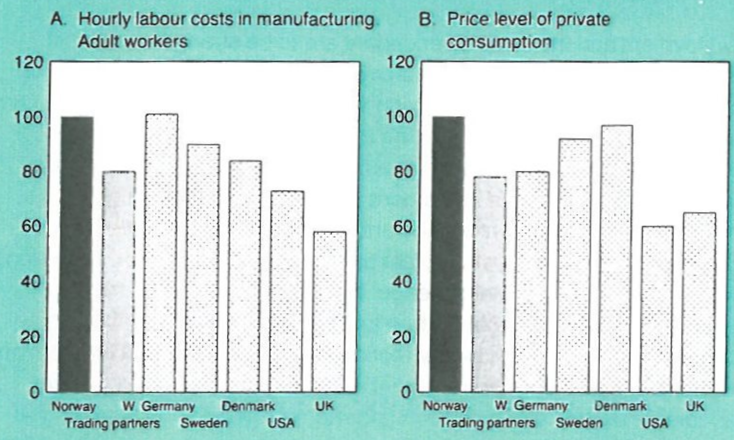
If employment and the external economy are to be strengthened, cost competitiveness will have to be improved in the 1990s so as to bring our cost level down to gradually approach the average of our competitors. Our relative cost level is influenced by the exchange rate, and the trend in productivity and labour costs. In present circumstances, exchange rate policy is not an appropriate instrument. A devaluation would trigger off a sharp increase in interest rates and encourage the view that we could continue to «solve» our cost problem by this means. It is doubtful how long it would give us any competitive edge. Nor can we expect the trend in productivity to be notably better than among our competitors. The productivity gain in 1989 is hardly replicable and, ensuing as it did from an almost 6 per cent drop in employment in manufacturing industry, is not desirable. Thus the key lies in reducing wage growth to a rate below that of our competitors. The basis for this was laid towards the end of the 1980s after we had repeatedly awarded ourselves pay increases not backed up by increased production.

The results were achieved by unconventional means. The first incomes regulation act undoubtedly contributed to curbing cost growth; the effect of the latest one is less certain. Wage growth in the two years as a whole was nevertheless only 1 per cent lower than the average of our trading partners. In the interests of the jobless and of employment, the greatest possible restraint should be shown in the spring wage round. A small wage carry-over, reduced pressure on prices and minimal pressure in the labour market have engendered a hope that it will be possible to contain the increase on an annual basis within a ceiling of 3½ per cent. The outcome in the period ahead will depend on the attitude adopted both by the trade unions and the employers. All parties ought to be concerned not to allow the gains of the past two years to be squandered.

Income equality is an important priority of our wages policy, and the wage legislation of recent years has worked in the same direction. It may reasonably be assumed that this policy enjoys considerable support, at least in principle. However, the more strongly it is applied, the further the wage structure is removed from market conditions, and both pressure of market forces and the employment effects incurred by a wage level which in several sectors has risen higher than the product market can sustain, are aggravated. We therefore have to strike a balance between the desire for equality on the one hand and price stability and employment considerations on the other. This does not mean actively advocating wider income differentials. What it does mean is that the economic costs of an egalitarian incomes policy cannot be overlooked.

It must, however, be admitted that citing market forces as a basis for the development of wages gives less guidance for practical wages policy than might be wished. This is partly because the market is regulated by the workers' and employers' organisations, partly because officially stipulated prices in important sectors are crucial for enterprise earnings. Moreover, as our largest employer, the public sector risks being a trend-setter in wage settlements for groups in which there is a fairly high level of unemployment.

Chart 7.
Prices and labour costs in Norway and among our trading partners in 1988. Norway = 100.



Hourly labour costs in Norwegian manufacturing industry were 25 per cent higher than the average for our trading partners in 1988. Only West Germany matched the figure for Norway. However, Norway's high wage level is accompanied by a higher price level than in other countries. The price level of private consumption was 28 per cent higher than among our trading partners. Only Denmark had a price level approaching the Norwegian.

Source: Central Bureau of Statistics

When presenting our wage demands we must not forget that in the end we have ourselves to foot the wage bill. The Central Bureau of Statistics has shown that our high wage level is accompanied by a higher level of prices than in other countries. Higher wages are eroded by the high prices needed to pay for the high wages, and the net result is a level of real income somewhat below that of countries we tend to use as a basis of comparison.

To the extent that the high wage level increases unemployment, the costs are first and foremost borne by those who lose their jobs, but also by the employed who have to support the jobless. It is only to the extent that a high wage level is buttressed by wealth depletion and must therefore be paid for by coming generations that we can for a time enjoy a higher standard of living.

A market-determined cost of capital gives a better structure

Until recently our high level of wage costs was combined with a low cost of capital. This further contributed to bringing the unemployment rate to its present level, since it created a preference for capital instead of labour. Nevertheless, this is the area where, perhaps, so far structural policy has proved most successful. We have managed to establish a better framework for resource allocation by allowing the market to determine the price of capital to a much larger extent than previously. A tighter credit policy, coupled with tax reform and a decrease in the inflation rate, has contributed to a real positive interest rate on borrowings by both households and enterprises. A deregulated credit market combined with higher real interest rates will over time contribute to higher returns on our investments.

In the past year, it was decided in principle to dismantle the foreign exchange regulations, and central provisions of the foreign exchange regulations were rescinded. This has provided business and industry with the opportunity to adjust their foreign currency position, and bring them into line with their foreign competitors. This on its own represents a considerable improvement in the conditions under which parts of business and industry operate, although the effectiveness of the regulations had already been reduced. The dismantling of the foreign exchange regulations also contributes to strengthening competition in, and thus improves the efficiency of, Norwegian financial markets.

Although some steps have been taken to increase the return on capital, there is still much to be done. Efficiency considerations make it desirable to subject all investments to uniform general conditions. Against this background, it is rather unfortunate that the real growth in the state banks' commitment quota has been about 40 per cent over the past three years. The high priority given to housing development contributes to resources being kept in the sheltered sectors of the economy, while it places heavy constraints on fiscal policy as a result of the high level of interest subsidisation. However, of greater importance are perhaps the effects of today's tax system and subsidisation of business and industry.

Fiscal neutrality gives a better structure

The tax system operates directly on business and industry's basis for making the optimal investment decisions and influences the possibilities of giving the public the correct signals regarding the choice between consumption and saving. In this area the authorities cannot strengthen structural policy solely by standing back. On the contrary, they must take action to make the system more fiscally neutral.

The changes in personal taxation made in 1987, with greater weight placed on taxation of gross income, has contributed to diminishing some of the negative features of the tax system. The reduction in the highest marginal taxation on net income from 66.4 per cent in 1986 to 43 per cent this year entails that the personal borrower must pay a larger proportion of his borrowing costs. However, deduction for interest payments still contributes to a substantial proportion of loan costs being charged to the tax bill. Correspondingly, individuals who pay a wealth tax still have to consider seriously how to make their investments in order to to obtain a positive real rate of return on their financial assets.

The Aarbakke Commission (Tax Review Commission) points out in its report that much remains before the tax system minimally affects economic behaviour. Today's system for corporate and capital taxation entails that the required rate of return on real investments varies widely according to the firm's ownership structure, financing structure, type of business and geographical location. It is generally very low and can easily turn negative. Consequently, the tax system may turn investments with a negative return for society into ones with a positive return as seen from the private investor's viewpoint.

These effects are partly due to favourable depreciation allowances and allocation schemes that qualify the investor for substantial tax credits. Furthermore, taxation on housing and other forms of real capital is very moderate. Combined, these factors go a long way to explaining the low rate of return on capital in Norway compared with other countries. A greater degree of neutrality in the formulation of corporate and capital taxation, in order to achieve a better match between the rate of return on financial and real investments, will both increase the rate of return on capital employed and strengthen the external balance. As long as the tax system favours debt creation, it is no wonder that the country as a whole is going further into debt.

The interest rate must accommodate foreign exchange considerations

While the possibility of stimulating activity through fiscal policy is limited by budget constraints, foreign exchange policy considerations place constraints on monetary policy. A good three years have passed since pressure in the foreign exchange market led to a strong upward adjustment of Norges Bank's overnight rate. This led to an increase in the interest rate level in the credit market which contributed to a slowdown in the demand for credit. On the basis of an assessment of the foreign exchange situation and domestic credit supply in the spring of 1988, Norges Bank found that market rates warranted a reduction of the interest rate on loans from the central bank to banks. The succesive reductions of the central bank rate spilled over into the credit market. Domestic credit regulations were dismantled on the basis of both their ineffectiveness and redundancy.

The overall credit supply remained within the stipulated target area as a result of the policies implemented. In the course of last year a considerable portion of the foreign exchange regulations was rescinded. The deregulation process continues this year and the remaining regulations are now of minor significance for demand management. As the tax control and statistical problems are being taken care of by other means, the remaining regulations will also be dismantled.

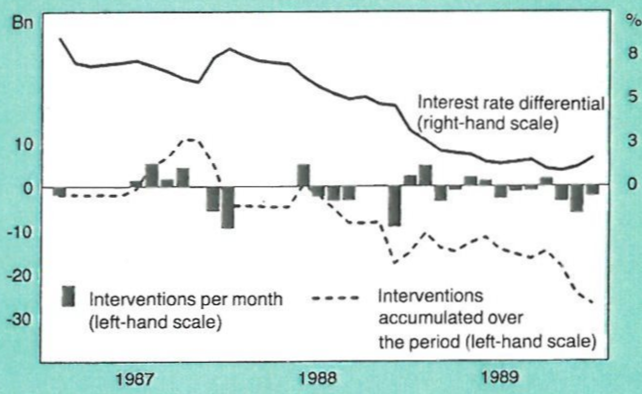
A tight monetary policy?

It has been common to regard monetary policy in this period as tight. Whether this is so depends on the criteria applied.

As already mentioned, that the state banks' commitment quota increased by 40 per cent from 1986 to 1989, and this can hardly be called tight. However, since the government budget finances the loans or guarantees them, it would be just as natural to regard this part of the credit supply as an extension of fiscal policy, and instead link the discussion around monetary policy tightness to developments in the private credit market.

The level of interest rates has generally been as high as foreign exchange stability has required. Nevertheless, we have seen a certain decline in the

Chart 8.
Interest rate differential vis-à-vis other countries, and foreign exchange interventions[1] 1987–89.



[1] Negative figures denote purchases of kroner.

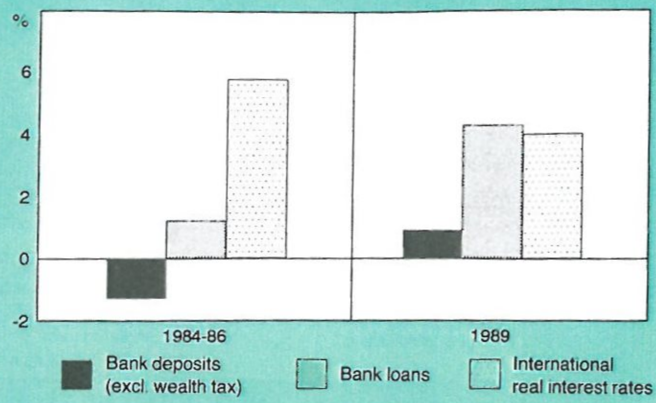
Since late autumn 1986, the interest rate in the money market has largely been set with a view to maintaining a balanced foreign exchange market. Not until the spring of 1988 was the exchange market situation conducive to a reduction of Norwegian money market rates in relation to other countries. However, the decline in interest rates has also been buttressed by interventions in the foreign exchange market totalling about NOK 26bn over these three years. (Interventions are depicted as a curve and monthly as columns). Given their magnitude, the foreign exchange interventions have had to be financed with the aid of both the current yield on the foreign exchange reserves and government borrowing abroad.

Source: Norges Bank

foreign exchange reserves, since Norges Bank has had to sell foreign exchange at the prevailing interest rate to maintain a reasonably stable exchange rate. This may indicate an expansionary monetary policy stance that has provided the public with the kroner necessary to purchase the foreign exchange. To a large extent this has been offset by the restrictive effect of interest payments to Norges Bank. It can therefore perhaps be argued that monetary policy has been approximately neutral, but the figures cerainly do not indicate any tightness.

Since market confidence in the Norwegian krone has been strengthened, it has been possible to maintain a reasonable degree of foreign exchange stability, even with the fall in interest rates. The interest rate differential, in relation to a weighted average of other currency rates, where the currency basket's composition is used as weights, has narrowed from 8.5 per cent in January 1987 to between ¾ and 1½ per cent throughout most of 1989. The interest rate on long-term and medium-term loans from banks has fallen from 15.6 per cent at the end of 1986 to 14.4 per cent at the end of last

Chart 9.
Real after-tax interest rates, 1984-86 and 1989



A low-interest-rate policy, high inflation and detrimental tax treatment of investment income and expenditure meant that up to the mid-'80s household borrowing costs were substantially lower than the borrowing costs faced by Norway as a nation (i.e. the real interest rate on loans raised in the capital markets of our trading partners). Concurrently the return on financial investments was negative. The reorientation of monetary policy, lower inflation and revision of the tax system have now brought domestic borrowing costs more or less into line with borrowing costs for the nation. Return on financial investments remains low, however, contributing to a low savings ratio in the household sector.

Source: Norges Bank

year. Bond market rates have fallen by about 2.6 percentage points in the same period. The decrease in the nominal interest rate level does not indicate a tight credit policy.

However, since 1986 the real rate of interest after tax for personal tax payers has increased by 3 per cent for average incomes and by a good 5 per cent for incomes with the highest tax deductibility for interest expenses. This is partly due to a lower rise in prices, partly to changes in taxation. For average incomes the first factor has been more important; for higher incomes the latter. Even after these changes, the real rate of interest on bank loans after taxes for average incomes is no higher than the real rate of interest in the international money market, which we can use as a reference for opportunity cost of capital. However, this price refers to securities which are considered to be risk-free, whereas the interest rate in the credit market also has to cover a risk premium, cost of intermediation and profit. Moreover, we must not forget that there are cheaper loans in the market than bank loans.

For business and industry, which were spared a corresponding tax increase, the real cost of borrowing has not increased to the same extent as for private individuals. With the liberalization of the foreign exchange regulations, enterprises have gained access to loan capital on international terms.

It is probably this rise in the real after-tax interest rate which gives the public the impression that monetary policy has been tight. However, this tightening started at a time when the cost of borrowing, measured in this way, was markedly negative, and therefore reflects more than anything the weakness of the monetary policy conducted in the past. Today's problems are in fact the legacy of many years' cost-free borrowing.

Despite the interest rate increase, the real rate of return on financial assets after tax is minimal, especially when wealth tax is taken into account. In a longer term perspective, this is probably a greater deterrent to capital formation than the fact that the cost of borrowing is now at a realistic level.

The focus on low interest rates

Despite the new orientation of monetary policy, one may often get the impression that reducing the interest rate level is an independent objective of economic policy. In Norway public opinion seems to focus on the interest rate to a larger extent than in other countries. A reason for this could be that Norwegian households are net debtors, whereas in most countries they are net lenders, since it is quite common for the government to borrow money either directly or indirectly from the private sector. In our country the government is the largest single domestic holder of financial assets. As long as we do not conceive of the government as representing ourselves, we believe that we benefit from lower interest rates.

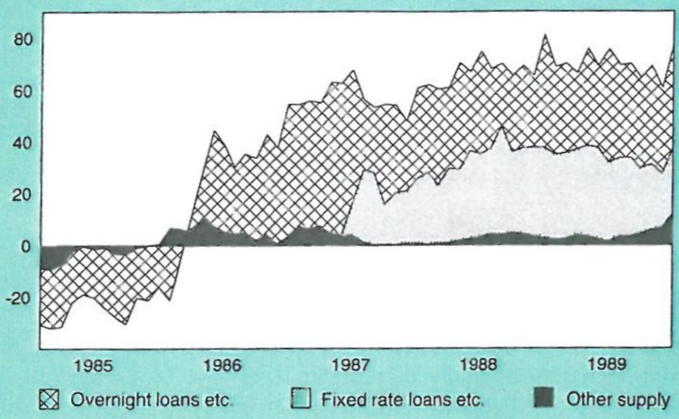
There can hardly be any doubt that several conditions conducive to a low interest rate level, such as price stability and high capital formation, are also generally beneficial to the country's economic development. However, if these conditions are not satisfied, very little can be achieved by an interest rate level which is lower than what is compatible with market conditions.

In-depth analyses have shown us that the level of interest rates has uncertain and dubious distributional effects. It does not stimulate employment; on the contrary, a lower cost of capital makes it more profitable to replace labour with capital. Lower interest rates do not stabilise the price level, since the short-term effect of lower interest expenses on prices is easily lost through higher demand. Nor does it give higher economic growth on a sustainable basis; on the contrary, economic growth will be undermined if the lower interest rate level leads to weakened balance in the foreign exchange market. Even if a strong economy entails a lower interest rate level, we must not be misled into believing that a low interest rate level entails a strong economy.

Norges Bank as state bank for the banks

It was the belief in the efficacy of cheap borrowing which led the political authorities in the period 1985-86 to set a level for the money market rate which could only be maintained by an increase in Norges Bank's lending to banks. As the banks' primary and supplementary reserve requirements under the Monetary and Credit Policy Act were dismantled, lending from the central bank could be reduced somewhat. Beyond this, the aggregate supply of liquidity from the central bank to the banking system fluctuated in the area of NOK 60-75bn in the period 1987-89.

Chart 10.
Central bank financing of the banking system, 1985-89 (adjusted for reserve requirements for banks). Billion kroner.



An expansionary monetary policy in 1986, whereby a deficit on the balance of payments of the private sector[1)] was met by reducing the foreign exchange reserves, was matched by a strong increase in overnight borrowing by banks from the central bank. Hence, changes in the overnight lending rate required banks to make rapid adjustments on the income side of their accounts. Therefore, in 1987, a fixed-rate loan arrangement was introduced involving longer loan maturities for which the interest rate is fixed for the entire term of the loan.

[1)] = non-financial private sector + municipalities

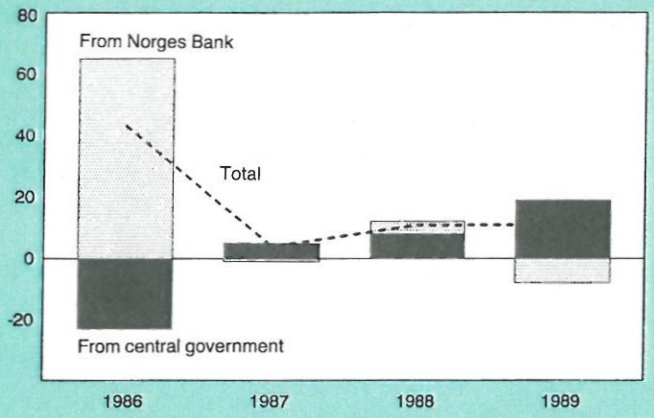
Source: Norges Bank

In relation to other countries, Norwegian banks show an exceptionally high level of borrowing from the central bank. There are several drawbacks to this.

Most central bank credits are supplied in the form of overnight loans that individual banks can borrow within a set quota in per cent of a calulation basis (a bank's total assets less overnight loans from Norges Bank). The interest rate on these loans can be changed from one day to the next, and any interest rate change promptly affects the general interest rate level, also for mortgage loans. However, this is not required for the the money market rate's role in defending the krone exchange rate. Since a change in the central bank's overnight rate quickly spills over into the money market, this instrument has received political focus in such a way that it has become less flexible than desired. A change in the central bank's overnight rate will necessarily emit certain signals, but these are by no means marching orders. It must be the banks' responsibilty to set interest rates, independently of the central bank's interest rate on overnight loans.

Norges Bank has regularly distributed loans to banks by auction, for a fixed period, partly with a view to dampening the impact on banks' lending rates

Chart 11.
Main sources of krone supply to the private sector[1]), 1986-89. Billion kroner



Norges Bank's interventions in the foreign exchange market in support of the kroner reflect a deficit on the balance of payments of the private sector[1]). This must be financed by supplying the private sector[1]) with kroner. In 1986, when the overall krone supply was very high, the most important source was Norges Bank. Central government transactions have supplied an increasing volume of liquidity since 1987. In the past three years the liquidity supply from Norges Bank, changes in primary and supplementary reserve requirements and in the private sector's cash holdings, and the withdrawal of liquidity via banks interest payments to Norges Bank, have largely neutralised each other.

[1]) = non-financial private sector + municipalities

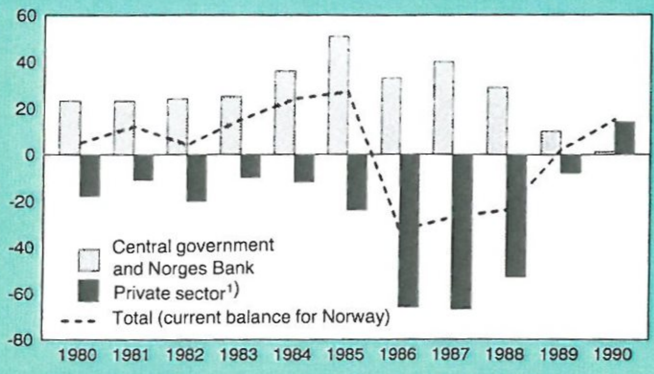
Source: Norges Bank

and partly to bring the central bank's lending terms closer in line with market terms. Our experiences with this approach have generally been positive, but one cannot avoid that banks with liquidity problems show the strongest interest in such loans, and therefore Norges Bank's position becomes more vulnerable. In order to mitigate this effect, certain limits have been set in relation to the individual bank's equity capital.

The turbulence which has recently shaken the banking system, has also entailed loan losses for Norges Bank. The write-offs on the loan to Sparebanken Nord-Norge came to NOK 500m and we can also expect write-offs on the loan to Norion Bank. These are public resources that could have been put to better use, to put it mildly.

Another feature of central bank lending is that it favours the banks since under this arrangement they are given easier access to funds than other types of financial institutions. Ordinarily, this would not be of any great consequence, but the volume of these loans has become so high that one cannot disregard the competitive distortion it entails.

Chart 12.
Financial investments distributed on central government and the private sector[1], 1980–90. Billion kroner



Central government (incl. Norges Bank) has traditionally had large positive financial investments in Norway. Even after the oil price fall, financial investments remained at a high level owing to Norway's cyclical upswing up to 1987 and the tightening of fiscal policy in 1986-87. Private sector[1] financial investments fell sharply, however, in 1986, and a substantial current account surplus was replaced by a wide deficit in 1986. The improvement in the external economy in recent years is primarily due to a sharp improvement in private sector[1] financial investments. Central government financial investment has weakened substantially.

[1] = private sector + municipalities.

Source: Norges Bank

For these reasons and many more, Norges Bank would welcome a shift away from central bank credit towards other sources of funds for the banks. This presupposes that such a transition could be worked into general economic policy. Even with the present volume of central bank credit, there may, however, be grounds for a closer examination of the instruments involved.

Where does the money come from?

Norges Bank's liquidity policy is geared towards accommodating foreign exchange stability considerations and keeping domestic credit supply growth within the target range of 5-9 per cent stipulated in the National Budget. The latter guideline is subordinate to the first, but for the time being these two objectives do not seem to conflict. After the liberalisation of money and capital markets, it is uncertain how long this form of credit supply targeting will remain a valid guideline.

Foreign exchange policy stability requires that foreign exchange reserves are adequate to prevent a short-term capital outflow from forcing a devaluation. A common method of guaging the size of foreign exchange reserves is to measure them in relation to the country's imports. By this yardstick, they have fallen from 43 per cent at the end of 1986 to 35 per cent by the end of last year. This is still a perfectly adequate level, although it is difficult to define clear criteria for how large foreign exchange reserves should be. Generally, one can say that the more one-sided the economy, the larger the foreign-held stock of the country's own foreign exchange, and the more expansionary fiscal policy is, the larger the foreign exchange reserves should be. Based on these critera, the need for foreign exchange reserves has grown in recent years.

Net sales of foreign exchange by Norges Bank — interventions — must be financed by supplying the banks and their customers (the public) with kroner in one way or another. In 1986 this supply came from Norges Bank, in 1987 net interventions were moderate, and in 1988 and 1989 the most important source of krone supply was over the government budget and other public accounts. The decrease in the foreign exchange reserves was, however, limited by the withdrawal resulting from Norges Bank's domestic interest income from the banking system and the conduct of a relatively neutral liquidity policy.

In 1989, and particularly with the government budget for 1990, there is a new element in our economy's financial picture. Throughout practically the entire post-war period the government has increased its net financial assets. A large share of this has been channelled to the state banks. The counterpart is a net debt increase for the private sector, including municipalities. It was particularly strong in the years 1986-88, when we also had a large deficit vis-à-vis other countries. Last year saw a strong decrease in government lending, and this year it will virtually disappear. This is taking place despite an increase in oil revenues. As the future outlook now appears, one has to expect that this tendency will continue over the coming years. Based on previous experience, it is easier to loosen fiscal policy than to tighten it. At the same time, the private sector is becoming net lenders instead of net borrowers. The effect of this quite marked shift can be found in the surplus on the current account and lower private demand.

In the present situation, the government will finance an increase in net borrowing by drawing on its deposits with Norges Bank, and the same applies to its lending to state banks. This will inevitably lead to a strong increase in the government's supply of kroner to the private sector, which gives the basis for net purchases of foreign exchange from Norges Bank. With such an expansionary liquidity policy on the part of the government, there are even less grounds for Norges Bank to increase its supply of liquidity to banks. On the contrary, the supply of liquidity from the Treasury that will ensue should provide ample scope for reducing central bank liquidity to banks, which I already pointed to as desirable.

If one aims at limiting the decrease in foreign exchange reserves which the added liquidity supply entails, the immediate result of such a measure will be a higher interest rate level than would otherwise be the case. However, in today's liberalised foreign exchange markets fairly small margins would be required, if the markets have confidence in Norwegian economy. But the interest rate may easily climb to higher levels if a policy is conducted that creates doubts in the market as to our ability and commitment to maintain foreign exchange stability.

This may beg the question of whether increased oil revenues can change the picture I have just painted. To answer this question we must refer back to the wealth depletion I discussed earlier. An increase in oil revenues means that perhaps we have added wealth to spend, but this will not be of any decisive importance to solving the long-term problems; nor should it influence our economic policy. The intended role of the oil fund was precisely to enhance such a long-term strategy.

Is the rate of interest a policy matter?

The necessity of securing balance in the foreign exchange market means that our own interest rate level will mainly be determined by the interest rate level abroad, over which the Norwegian authorities have no influence. Should Norges Bank try to exert downward pressure on the interest rate in relation to foreign rates, it would have to sustain an increase of central bank loans to banks, with a corresponding weakening of our foreign exchange position. Furthermore, Norges Bank's own position would become more vulnerable.

By exercising restraint in economic policy, we should, on the other hand, be able to sustain this position; however, we have already gained a «premium» by stabilising the economy through bringing the money market rate down to a level which has hovered between ¾-1½ per cent above the average we have calculated for the international rates, but which in the most recent period has been even lower. In the short term the movements may be somewhat coincidental. It could be argued that there is little reason for even this narrow interest rate differential to be maintained, and it is quite possible that it could turn negative. In either case our opinion is of little consequence. The market is the determining factor, and based on experience market confidence is not won overnight. It is not created by any single political action.

Against this background, restraint should be applied to expectations regarding interest rate developments. Realistic expectations must above all be based on international developments, and such forecasts naturally contain an element of uncertainty.

Given the significant narrowing of the interest rate differential already achieved, it will take less for the interest rate level in Norway to rise than to fall further. A higher price and cost growth or a more expansionary policy on the part of the government could easily have a significant impact.

Under the prevailing conditions, it is pointless to demand of the authorities a more stable or a lower interest rate level. The authorities are not in a position to accommodate such a demand, and an attempt to do so would probably produce the opposite effect. On the other hand, of course, market developments may result in a lower interest rate level.

Establishing norms

Norges Bank's constant emphasis on the necessity of a sustainable balance is only another means of expressing the importance of a long-term policy perspective.

The success of such a strategy depends on the ability to win a reasonable degree of acceptance for certain norms of behaviour in economic policy. This should be possible in a country where the fundamental conflicts are no greater than in ours. In certain areas it seems we are gaining ground.

One example is the growing acceptance of a market-oriented monetary and credit policy. Under the general guidelines concerning foreign exchange stability and the credit supply, Norges Bank's function is to contribute to the establishment of orderly markets, i.e. to limit short-term fluctuations in both the interest rate and the exchange rate. In a market-oriented system, the central bank's role in the market does not extend beyond this. If the price, in this case the interest rate, is set by or through a market participant as important as the central bank, the system is no longer a market-oriented system.

Against this background, as I have already shown, Norges Bank has built on the assumption that as long as the total domestic credit supply remains within the interval stipulated in the National Budget, an increase in central bank financing of the banking system should be avoided. We have practised this norm with a large degree of flexibility, but, seen over time, we have nonetheless been able to maintain this form of liquidity supply within reasonable margins. It is not a particularly stringent norm, and with the level which central bank financing has already reached, it may appear to be self-evident. It is nevertheless important, which a quick glance backwards to 1985-86 should confirm. If this norm had been applied then, instead of a norm for the money market rate, the jobless would probably have been several tens of thousands fewer than the actual figure today.

Establishing fiscal policy norms is of no lesser importance. The Government's objective of keeping public expenditure growth at a lower level than the growth in national income is, in this connection, a useful and quite exacting norm.

In other countries it would be natural to demand that the government should not finance a budget deficit by borrowing from the central bank. In our country such a demand loses significance, since the government can draw on its deposits with Norges Bank both to make good a budget deficit and to meet its other borrowing requirements, in particular lending to state banks. The economic effects of this are no different from those of borrowing from Norges Bank. A norm for financing the government's borrowing requirement must, therefore, be formulated as a norm for how much of it should be financed by borrowing in the market. Such borrowing will have an impact on interest rates, but it is this impact which should contribute both to budget policy restraint and a level of activity commensurable with the constraints imposed by the need for sustainable balance.

The opening of the Norwegian bond market to foreign investors will presumably limit the impact on interest rates of borrowing in the market, since a large proportion of the borrowed funds will end up abroad. It may be tempting to dampen even this limited impact by borrowing these funds in foreign currencies. However, doing this would mean the loss of the signal effect through the interest rate, an effect which can contribute to putting a brake on public borrowing. There are therefore good reasons for adopting the norm that the government should avoid increasing its net borrowing in foreign currencies.

The depletion of the wealth generated by the petroleum sector and the uncertainty connected with its future yield create a need for a norm which is quite peculiar to our country. In principle a set quota for transfers from a petroleum fund could constitute such a norm. With the petroleum fund as proposed, it remains to be seen whether the system will function in this way.

Barely a generation ago it was accepted as a norm that the government budget should not be in deficit before loan transactions. Then oil revenues reduced the constraints on the balance of payments, which made it possible for us to conduct a countercyclical policy once demand failed. We were less able to do so when demand pushed our capacity to the limit. The resulting imbalance has, over the years, developed a structure in the economy where full employment can no longer be maintained without a substantial and, perhaps, rising rate of wealth depletion. The most pressing task of our economic policy is to rectify this structure while the 1990s still provide us with a reasonably high level of petroleum revenues. Later — and for those who succeed us — the task will be far more difficult. Successful remedial action requires the re-establishment of norms to which we are committed, and the social conflicts which the adjustment of structural policies will bring about must be resolved within the framework of these norms.