Economic Perspectives

Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 16 February 1989

Three years have elapsed since the fall in oil prices presented our country with new economic realities. However at this time last year the changes had not yet pervaded our daily life, despite the burden of high interest payments. Progress towards a better balance was correspondingly moderate.

As the year wore on the new realities became increasingly visible. Job security is no longer taken for granted. But at the same time the adjustment process is starting to bear fruit. In a situation like this, adjustment fatigue is making itself felt. But this is also the very moment when it is essential that the long-term perspective be maintained.

The importance of this challenge is such that I have decided to use the time available to look at issues relevant to our domestic scene. The international economy which, by the way, seems to be faring surprisingly well, will have to be left to itself this year.

As an introduction it might be appropriate to consider the current stage of the economic adjustment process and compare today's situation with five years ago when we departed from a reasonably well-controlled growth process.

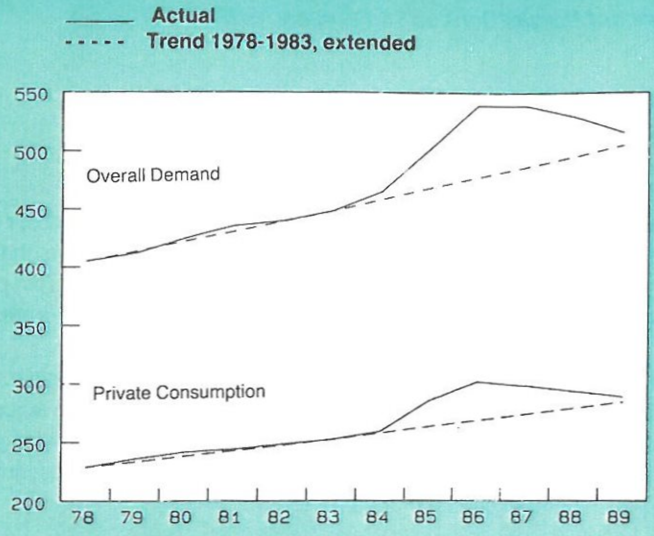
It is equally important to look at the adjustment process in a long-term perspective. It is through our actions now that the stage will be set for the 1990s, and even the turn of the century is no further ahead than 1978 is behind us. The success of the adjustment process hinges above all on creating a climate for business and households which is conducive to growth. Therefore an examination of the progress made so far seems warranted as well as a survey of the challenges ahead. Norges Bank has a particular responsibility as regards developments in financial markets. Experience and future prospects in this area will therefore be elaborated in some detail.

Demand back on the previous track

1986 was a peak year for private consumption, the current account deficit and inflation, while household savings reached an all-time low. Since that time economic policy has been restrictive. This restriction appears, however, not to have gone beyond a correction of the excessive rise in demand during the expansionary period 1985-86.

To illustrate this development we will look back to the five-year period 1978-83. This was a period during which domestic demand, under changing governments, corresponded reasonably well to the pace of domestic production growth. The shift from a substantial deficit to a surplus on the current account was essentially due to the rise in oil prices.

Chart 1.
Private Consumption and Overall Demand[1]) Mainland Norway. 1987-kroner, billions



[1]) Excl. inventories.

Source: Central Bureau of Statistics and Norges Bank.

Both private consumption and overall demand in Mainland Norway showed a sharp increase between 1984 and 1986. The decline in 1987 and 1988 is expected to continue in 1989. Even so, we are still not down to the level we would have been at had the growth rate of 1978-1983 continued.

Let us prolong the trend in Mainland Norway's domestic demand[1]) in the period 1978-83 through 1989. In this scenario we see that in 1989 actual demand would still have remained above the trend level. The same is true for private consumption.

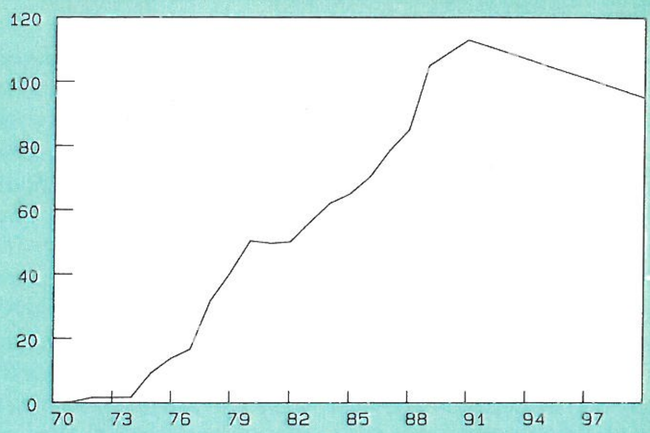
However, the basis for this growth in demand was no longer the same. Working hours had been reduced and, above all, the value of oil exports had declined following the price drop in 1986. These two factors should have induced a slowdown in domestic demand growth compared to its previous path. Instead, we allowed the previous gradual debt reduction to be replaced by a renewed increase in net debt.

Admittedly, it would be neither possible nor desirable to let domestic demand contract fully in line with the decline in oil prices. However, so far, the contraction has merely represented a downward adjustment to a more normal growth rate. The adjustment to a new situation in the petroleum market still remains.

The decrease in domestic demand over the past two years is only partially due to restrictive policies. It is, largely, the result of households' need to reduce their indebtedness. The resulting decrease in consumption would

[1]) Excluding inventories.

Chart 2.
Norwegian Gas and Oil Output to Year 2000.
Million tonnes of oil equivalent.



Source: Central Bureau of Statistics and NOU 1988: 21

Norwegian production of oil and gas will peak early in the 1990s, only to fall towards the end of the century to a level probably below this year's. Gas will make up an increasing share of Norwegian petroleum output in the second half of the 1990s. Growth in gas production will depend on market demand.

necessarily spill over into investment and the general level of activity in the business sector. This situation must be expected to continue in 1989 and against this background it can be argued that further tightening of policies is no longer required. On the other hand, there seems to be little basis for a policy of stimulating demand by government intervention in order to attain higher growth.

On two previous occasions we have fuelled growth through such policy. First, in the 1970s when there was the certainty of large and increasing revenues deriving from petroleum production in the North Sea, and then, in 1984 when OPEC II and a rising dollar increased our wealth beyond expectations and oil prices were expected to continue upwards. In such circumstances frugality does not come naturally.

Planning the downturn

This time difficulties will have to be met quite differently. Petroleum production is already nearing its peak level.

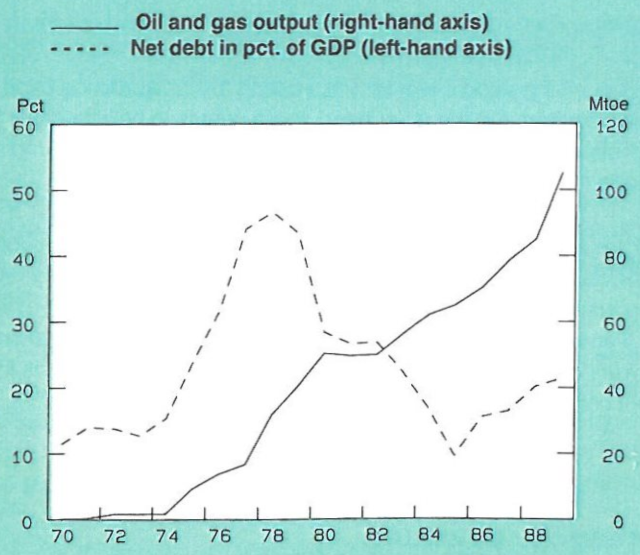
A 20% increase can be expected this year. Production will continue to climb in the next few years, followed by a downward trend during the latter part of the 1990s to a level somewhat below the present by the year 2000. Beyond that a further decline must be expected. Moreover, the gradual shift in output from oil to gas means that petroleum revenues will depend as much on sales prospects as production capacity.

The sales value of this production is highly uncertain. We may experience both higher and lower prices and probably both. There is greater confidence in a rising trend in the long term especially for oil. But as I have already remarked, our production trend will soon be falling.

The aim of achieving «sustainable development» in the global environment — to borrow a phrase from the Report of the World Commission on Environment and Development — strongly points to a need for international agreements on the use of fossil fuels. However desirable they may be, such agreements would add to the uncertainty surrounding the quantity and value of our own petroleum production.

I have purposely avoided referring to our sale of oil and gas as «petroleum revenues». Although oil and gas production is entered as revenues in the national accounts, our petroleum reserves in fact represent part of our national wealth. During the years 1980-85 some of this wealth was transformed into an increase in net financial assets. However, even in these years our total wealth accumulation was at a postwar low. Since 1986 our oil wealth has ebbed and the debt level has swelled. In the next few years, when increasing petroleum production adds to the value of our exports, this has its counterpart in our petroleum wealth being depleted at an even quicker pace than before.

Chart 3.
Norway's Net External Debt, and Oil and Gas Production.



Norway's net debt rose steeply between 1974 and 1978. Increased oil and gas production was confidently assumed, and a counter-cyclical policy was pursued based on expected revenues. In the years 1979-1985 a substantial share of revenues from petroleum sales was used to service the debt. Since 1986 the net debt has risen anew, concurrent with quickening depletion of our petroleum wealth. The rate of debt increase gives greater cause for concern now than in the 'seventies since oil output has multiplied and will fall back again in only a few years' time.

The population's age distribution is such that the next generations' burden will be considerably heavier to bear than ours. It would be rather unfair to compound this burden by leaving a heavy foreign debt behind as revenues deriving from petroleum production wither away. As we approach a period of declining production at the end of this decade, a minimum goal should be that our net debt position is eliminated by then. It would not be unreasonable, in fact it would be desirable, to transform some of the petroleum wealth into net assets which could dampen the impact of the future decline in production.

The Petroleum Depletion Commission of 1983 suggested that the government's petroleum revenues should be channelled through a fund to cushion fluctuations and ensure a stable and predictable transfer of revenues to the government budget. To the extent that it accumulated assets, it would also compensate for the decrease in wealth as resources were depleted. The proposal received wide political support before it was shelved. I note with interest that the idea is again receiving attention. Even though budget techniques can never replace politics, politics can be assisted by budget techniques.

With a dash of luck as regards oil prices our current account may already be back in balance this year. But given the production trend, the objective of a balanced current account and eventually a reduction in the net debt could not be postponed for long anyway. When production starts to decline this objective will be much more difficult to attain than in a period of growing production.

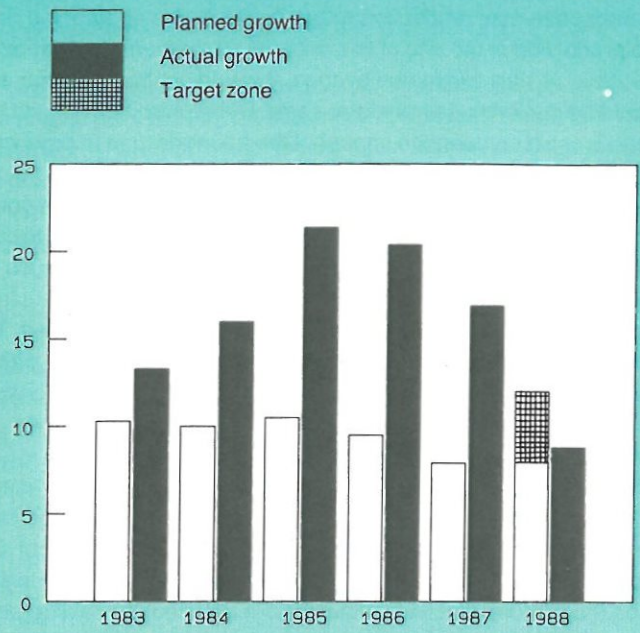
A long-term strategy aiming at a balanced economy even after the oil era will be difficult to pursue in a climate of a more favourable current balance and growing unemployment. Certain measures, such as speeding up public investment projects, do not conflict with already approved strategy but nor do they constitute a viable solution. Investing in human capital and more highly skilled labour is useful in and by itself but will give full benefit only if there is demand for these skills in the labour market. We must realize that there are no easy solutions to our problems and that the responsibility for the present situation rests squarely on ourselves. Our present situation is the product of 15 years of counter-cyclical policy, the oil boom, and demands for higher standards of living. We may once again leave the problems to the future, a future which will probably have enough problems of its own. Or we can face them head on, acknowledge our responsibility and pave the way for durable solutions even if this involves a longer process.

Despite the increase in unemployment as a result of slowing demand, the adjustments undertaken so far have provided our economy with a better platform for future growth. Those sectors which are to provide income and employment when petroleum production starts to decline can only be in a position to do so if we are successful in establishing the appropriate framework for business and households. The cost of labour and capital constitutes a central element of this framework. The imbalances in the Norwegian economy can to a large extent be ascribed to the cost of labour having been higher and the cost of capital lower than warranted by the market. How far,then, have we come with respect to correcting these distortions?

Improving credit policy

In 1988 we abolished what remained of quantitative regulation in the credit market. This was also the first year in which we achieved our credit policy

Chart 4.
Domestic Credit Expansion. Annual percentage growth [1].



Source: Norges Bank and the Ministry of Finance.

Throughout the 1980s up to 1987, the actual credit supply to the private sector and municipalities from domestic sources was higher than planned in the National Budgets. Growth was notably higher in the years 1985-87. In 1988 the «credit budget» was replaced by a «target zone» for credit expansion. In that year the actual credit supply ended up in the lower half of this zone, largely because interest rates conformed to developments in the credit and foreign exchange markets. 1988 was the year that market-oriented credit policy finally made its breakthrough in Norway.

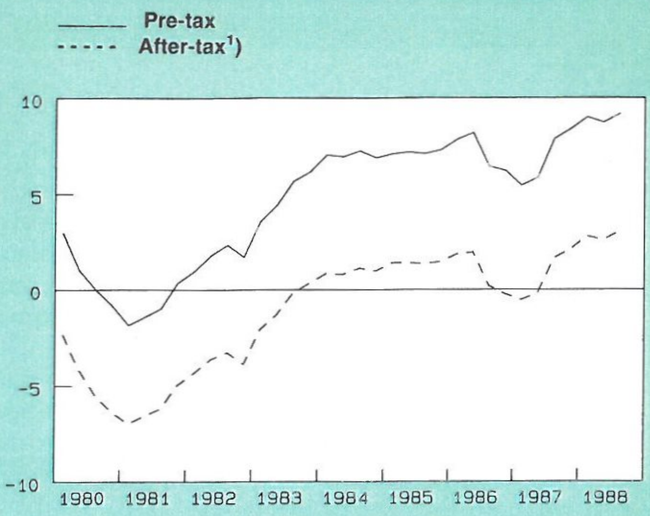
[1]) Adjusted for abnormal losses in 1989 and 1988.

targets. We can safely say that this represented the final breakthrough for market-oriented credit policy in Norway.

Whereas previously we attempted to force financial institutions into rationing credit, we now regulate credit demand by means of the price of credit. Of course, the price has to be higher than when we based ourselves on rationing. Real after-tax interest rates are now positive for all groups of borrowers, and differences between income brackets have narrowed considerably. It is less clear to what extent real after-tax rates for assets are also positive.

In view of the net debt burden incurred by the private sector, it is understandable that the interest rate level has become a matter of concern both in political quarters and elsewhere: the interest rate level has been widely considered too high. To have succeeded in gradually reducing it has given Norges Bank

Chart 5.
Real Pre- and After-Tax Interest Rates



Source: Norges Bank

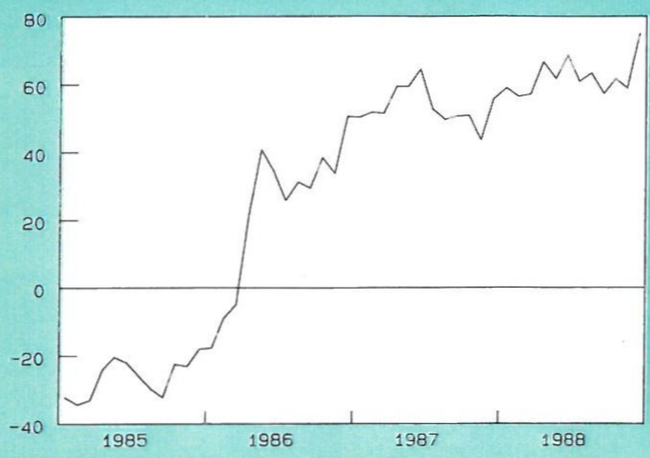
The chart shows quarterly figures for real pre- and after-tax interest rates. Real interest rates are defined as rates deflated by the rise in prices in the latest four quarters. In recent years, real interest rates have been particularly affected by price rise fluctuations, although changing nominal rates have also played a part. Real after-tax interest rates are calculated using the average marginal tax rate applied to interest expenditure. The tax reform has also pushed up real after-tax rates in the past two years, although mainly for higher income brackets.

[1]) For borrowers with average marginal income tax.

some measure of satisfaction. Even so, there is reason to question our reference point: Too high? Relative to what? It has not been too high in relation to the need for balancing the foreign exchange market. Nor has it been too high in relation to credit supply targets. Demand for loan capital has exceeded supply at prevailing interest rates, compelling Norges Bank to supply liquidity via the banking system to prevent higher rates. Thus, based on credit market considerations, the rates have clearly not been too high. Interest rates may have been too high to secure the level of investment and demand that many would have liked; yet the fall in demand is what has produced the sorely needed strengthening of Norway's external economy.

In fact, I think it fair to say that never during the post-war period has the level of interest rates been better adapted to policy objectives and other elements of economic policy. Even more would be achieved if slower inflation and continued revision of the tax régime made it possible to maintain the required level of real after-tax interest rates at lower pre-tax nominal rates.

Chart 6.
Norges Bank's Net Liquidity Supply to Banks[1])
Billion kroner



Source: Norges Bank

Up to the beginning of 1986 the authorities withdrew more liquidity from the money market than Norges Bank supplied. In 1986 the situation was the inverse. The net liquidity supply from the central bank had to be substantially increased to keep interest rates from rising. Net liquidity to the private sector continued to increase in 1987 and 1988. In view of the importance of overall balance in the domestic credit market the interest rate level has not been too high.

[1]) Total liquidity supplied by the central bank less obligatory reserves

Freer movement of capital

When credit policy was tightened it was essential to limit the capital inflow from abroad which would be attracted by the high interest rate level. Liberalization of the domestic credit market did not, therefore, extend to foreign transactions. On the contrary, some foreign exchange controls were tightened. At the same time we have been aware of the diminishing effect of such controls on the overall credit supply.

Last year's substantial narrowing of the interest rate differential between Norway and other countries has eased the return to gradual liberalization of the foreign exchange régime. Of special importance is the wider access given to firms to raise loans in foreign currency, which was further widened from the beginning of this year, thereby providing some relief from the high level of domestic interest rates. However, borrowing in foreign currency involves a risk which most firms would prefer not to run. With the gradual convergence of Norwegian and international interest rate levels, the objections to capital inflow via sale of krone bonds abroad will abate.

The Monetary and Credit Policy Commission has recommended gradual abolition of foreign exchange regulation. Both the ineffectiveness of controls, and the costs of regulation borne by business and industry, lend credence to this view. Moreover, adapting to international developments may also require such a move to be taken. This will make it even more essential to bring tax treatment of interest payments more into line with international practices.

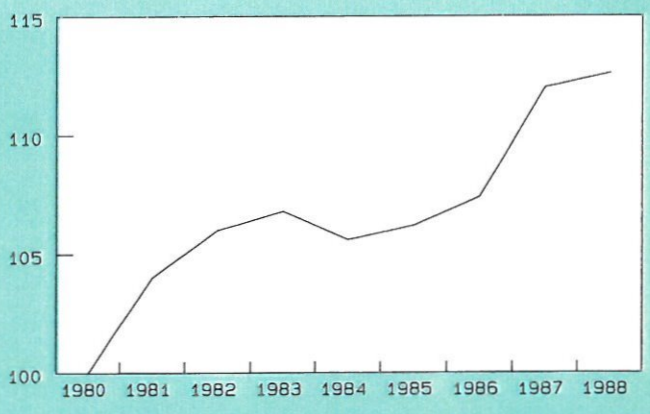
The cost of labour

Wages are determined partly by collective bargaining between the organizations in the labour market and partly at enterprise level. This dual wage determination process has in practice caused our wage costs in most years to increase faster than in competing countries, with the result that labour costs in Norway's exposed sector are among the highest in the industrial world.

Last year it proved possible, thanks to a moderate income settlement and special legislation limiting income rises, to maintain our relative cost level, which despite the devaluation in 1986 had weakened by about 6% since 1984. Entering 1989 with slower cost growth finally gives us a chance of regaining some of the ground lost. With no contractual wage increments and wage drift at half the normal level, relative unit costs in manufacturing could fall by 2-3%. Given our initial position, we should not aim for anything less.

Compared with an ordinary settlement in a tight labour market, last year's income policy achievement gives grounds for some satisfaction. But it does not

Chart 7.
Relative Unit Labour Costs in Manufacturing.
1980=100



Source: Ministry of Finance and Central Bureau of Statistics

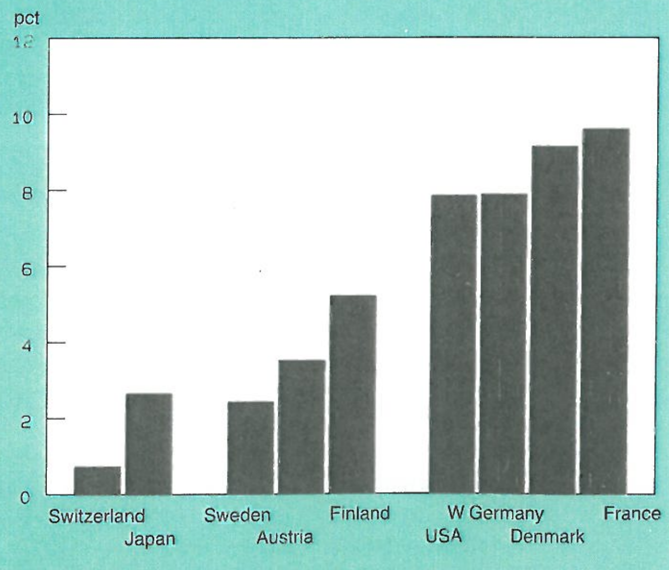
Labour costs influence costs in exposed sectors directly by the price of labour and indirectly by the price of capital goods and inputs manufactured in Norway. The growth in relative unit labour costs shows that Norwegian industry's competitiveness in manufacturing in Norway has deteriorated in the 1980s. Relative labour costs have increased by an average 12.5% since 1980 which corresponds to an average competitive depreciation of 1.3% per year. Measured in national currency this figure is all of 3%.

give the improvement in our position necessary to achieve greater diversification of Norway's business and industry. And we know there are limits to how long the regulatory measures now in effect can be continued. Identifying the problem is easier than solving it. However, a look at the experiences of other countries may aid our understanding of the problem.

With some simplification, countries can be divided into three groups: those where wage formation is highly flexible, those where there is some sort of acceptance of government or other centralized intervention to determine the level of real wages, and those where neither is the case. The first group includes Japan and Switzerland, with unemployment below 3% in the 1980s. The second group includes Sweden, Austria and Finland, with unemployment in the range of 3-6%. But most countries have an unemployment rate of 6-7% or more. They have neither flexibility in wage setting nor acceptance of centralized intervention, although there is some variation among them. A few countries have been in such persistent imbalance that it is impossible to judge what their position will be once they are forced into balancing their economy.

Norway has, more than any other industrial country, been able to draw on its national wealth during this period. We thus have most in common with countries which have been in continual imbalance. There has never been any great

Chart 8.
Unemployment in Various Countries.
Average, 1982-1987.



Source: OECD

There are wide differences among industrial countries' unemployment rates. Countries in the left-hand group have a relatively large degree of flexibility with respect to wage formation. Countries in the middle group have, to a certain extent, accepted government intervention in real wage determination whereas countries in the group to the right fall into neither category. Wage formation is a decisive factor influencing unemployment.

degree of wage flexibility in this country. Nor has there, until now, been any general acceptance of centralized determination of the real wage level. It is still too early to say whether a new attitude is starting to take root, and if so how deeply.

It is often said in our domestic debate that unemployment has become an economic policy instrument. This is hardly how it is felt in countries with persistent unemployment. They would certainly liked to have seen lower unemployment figures but have not had the opportunity, or may not have wished, to intervene in the process of wage determination. Nor have they been able to finance demand by drawing on petroleum wealth. Under these conditions unemployment is an indication that the labour market participants have not been able or willing to adjust to market conditions.

Continued tax reform

I said that the price of capital and labour are the two most central elements defining the economic environment within which business and industry have to operate. The tax system, however, drives a wedge between the price being paid and the income received. Such tax-induced distortions are unavoidable and do not obviate the necessity of taxes. But it makes the tax system an independent element in the framework confronting economic agents. The distortion implies a cost to the economy which we would have liked to minimize. Should we choose, under the influence of other considerations, solutions that increase these distortions we must be prepared to bear the increased economic costs this implies.

Both theory and practice tell us that a broad tax base with low tax rates produces smaller distortions than a narrow base with higher rates. In the case of income tax we have in the past three years made important moves towards widening the base and reducing rates. The highest income tax rate has been reduced from 71 to 62%, and average interest deductibility from 45 to 40%. Taxation of interest earnings has been reduced correspondingly. These moves were fairly crucial to establishing positive real after-tax interest rates in the case of higher incomes, whereas in the case of medium and lower incomes higher nominal interest rates and lower inflation have had a greater impact. So far, considerations of income distribution, and not so much of economic efficiency, have been at the forefront in the reform of taxation.

Such considerations invariably play their part in shaping tax policy. However, as the Committee on Income Determination showed, their impact on actual distribution may be smaller than we believe. Social security and benefits provide at any rate more effective means of redistributing income according to political priorities. Moreover, it may be easier — although difficult enough — to agree on what is expedient for the national economy than what is reasonable in terms of distribution policy.

We still need a tax reform with the central aim of reducing the economic costs of taxation. To achieve this requires a broader tax base, lower tax rates and less incentive for tax-motivated financial planning.

The household saving ratio, now turning positive, should continue rising to a level at which households, as a sector, can at least finance their own investments. However, if business and industry are to expand, households should have a financial surplus which can be deployed as loan capital and as risk capital. Revising the tax system can contribute in two ways: first, by ensuring that it does not undermine the real price of capital, either for the borrower or the lender, and, second, by not encouraging households to invest in housing rather than in financial assets.

Moreover, the effect of the tax system on corporate behaviour should also be as neutral as possible. The Government has now initiated work on corporate tax reforms. This work should be given the widest possible scope. What we achieve through our overall system of taxes and transfers to industry is hardly in reasonable proportion to the losses which tax planning inflicts on the national economy.

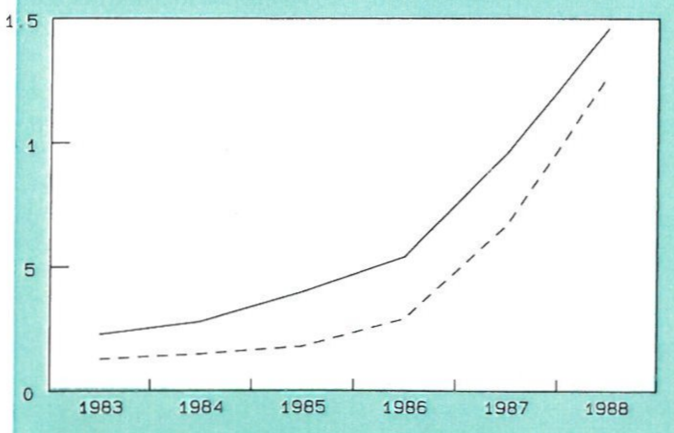
Improving financial markets

Market-oriented interest rates and a more neutral tax régime will help to ensure that the the financial system receives more correct signals of the expected profitability of the various investment projects seeking credits. Moreover, the financial system should have the strength and competence it requires to fill its role in the diversification of the economy. And it must be able to adapt itself to international developments in financial markets.

In last year's address I stated that 1987 had been a tough year for most groups of financial institutions. Not unexpectedly, 1988 proved even tougher, with bank losses likely to reach about 1.4% of total assets. Finance company losses in the past two years have been considerably higher. The insurance sector has also suffered sizeable losses and income problems, while losses of bond-issuing credit enterprises remain modest.

Chart 9.
Losses on Loans and Guarantees as a Percentage of Total Assets.

——— Commercial banks
- - - - Savings banks



Source: Norges Bank

Bank losses on loans and guarantees continued to increase in 1988. Loss increases were highest for savings banks.

What went wrong?

I would put the excessively high level of loan losses down to a combination of «bad banking, bad policies and bad luck». Inadequate credit risk assessment, poor management routines and the desire to win market shares by higher risk-taking were elements of «bad banking». Repeated upward adjustments of loss estimates in 1988 confirm that the institutions' grasp of the situation was inadequate until quite recently. Had they shown greater appreciation of the true situation, corrective action would have been taken at an earlier stage.

The authorities' responsibility for «bad policies» refers partly to a fiscal policy which for long was far too expansionary, but above all to the fact that they placed the entire burden of regulating the credit expansion on instruments aimed at influencing the banking system's supply of credits. The potent policy instruments available to the authorities to reduce demand, viz. tax rules and interest rates, were only brought into play towards the end of 1986. The central bank itself could be blamed for not having demonstrated more clearly the consequences of the interest rate policy imposed on it.

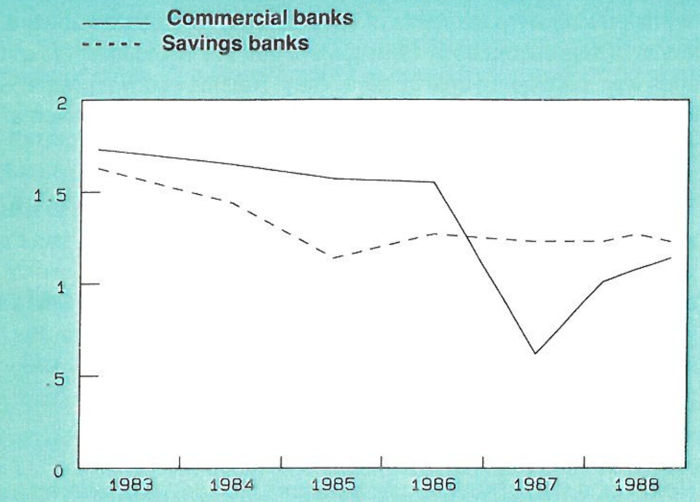
However, it should also be acknowledged that we have suffered a stiff dose of «bad luck». The drop in oil prices and consequent retrenchment that led to widespread surplus capacity could not readily have been anticipated. Also, it would be unfair to reproach those who incurred loans based on income expectations that appeared plausible prior to the oil price fall. Changes in the economic environment rendered it more difficult for financial institutions to make correct credit assessments.

Readjustment under way

It is our definite impression that financial institutions are now putting their house in order, resulting in far better organization and quality control of lending — also compared with the period prior to the credit boom. There is reason to hope that they will be in a stronger position when they emerge from the difficulties still facing them.

Despite their losses on loans, the banks' current situation is also brighter than at this time last year, the reason being the improvement during the year in their operating figures before losses, giving them a sounder buffer against losses. Naturally an important factor has been the absence in 1988 of the preceding year's heavy losses on securities trading. Moreover, operating performances showed appreciable improvement. The trend is more apparent for commercial banks than for savings banks, where a few of the larger banks detract from the overall performance. Overall, bank earnings are substantially higher at the start of 1989 than one year ago, thanks mainly to an increase in net interest income, which fell markedly from 1983 to 1987 for both commercial and savings banks. In spite of last year's improvement, however, banks have not yet fully recovered the ground lost since 1986. Moreover, there is doubt as to the durability of the latest increase in banks' net interest margins. Banks face competition on both the lending and borrowing side, and in the long run they will be hard put to maintain even their present level of net interest income. This being said, the fact that banks compete with each other and with other operators in financial markets is a prerequisite for efficient markets.

Chart 10.
Operating Profits Before Losses as a Percentage of Average Total Assets



Source: Norges Bank

Commercial banks' operating profits before losses declined in the period 1983-87. The worst year was 1987 with heavy agio losses on securities. Commercial banks improved their operating profits in 1988 as result of higher net interest levels. Savings banks' operating profits in 1988 remained at about the same level as in the period 1985-87.

In recent years banks have increased their charges, particularly for payments transmission services. Charging for services on the basis of real costs is a welcome contribution to more effective use of resources on the part of banks and to a sounder economy. As elsewhere in business and industry, price should be a means of competition, but not by virtue of costs being passed on to other parts of the enterprise. The same principle ought to apply to the payments transfer system of the Postal Services Administration.

The fall in net interest income in the period 1984-87 was largely compensated for by income from currency and securities trading. Although there has been a marked increase in activity on the Oslo Stock Exchange in recent months, it would not be desirable for banks or other financial institutions to base their earnings to the same degree as previously on short-term and uncertain gains on currency and securities trading. The only way to improve earnings in the long term is by efficient operation. The far-reaching expenditure cutbacks now being carried out by a number of banks and finance companies were initiated so late in 1988 that only in the current year will they make their full contribution to improving operating figures. However, the magnitude of the ongoing reduction of staff and branches must be viewed against the background of very strong growth in previous years. After all, the 5% decline in employment in 1988 succeeds yearly growth rates of a good 6% over the three preceding years. With this in view, the present exercise appears to be a necessary adjustment of capacity. The labour thus freed is well qualified and better placed than most to find work in other industries.

Banks initially covered their losses out of previous loan-loss provisions and current earnings. In the case of commercial banks, shareholders have in turn been affected through falling share prices and absence of dividend. Bank staff at all levels have been hard hit by redundancy. However, borrowers and depositors are also bound to be affected when banks increase their net interest income. But banks have no choice but to increase their net interest income if they are to keep up and expand their equity capital. True enough they can to some extent increase their equity capital by issuing shares and (in the case of savings banks) primary capital certificates, but only if the market is confident that such investment will yield a competitive return. After the experiences of recent years, market confidence does not come of its own accord.

Banking crisis

Last year, for the first time since the 1920s, banks lost their funds and became insolvent. But the safety net designed for such situations — comprising notably the banks' guarantee funds, the Banking, Insurance and Securities Commission and Norges Bank — functioned as intended. The crises in both Ålesund and Tromsø were resolved with a minimum of disquiet in the market, and international confidence in the Norwegian financial system was thereby maintained. This is of of vital importance since Norwegian banks rely to a large extent on foreign financing.

For the two major savings banks based in Tromsø, the foundation has been laid for a lasting solution in that the savings bank system, through its guarantee fund, has supplied the banks in question with new liable capital. Moreover, since the two banks provide a substantial share of banking services in Troms and Finnmark counties, it has been found appropriate that Norges Bank should help the new merged savings bank build up capital by making funds available at reduced rates of interest over a five-year period. This ensures a sound basis for re-establishing a viable savings bank system in Troms and Finnmark. Where Sunnmørsbanken is concerned, Norges Bank is providing liquidity on market terms. In due course a lasting solution can be expected to be found through the efforts of the commercial banks' guarantee fund.

As a result of the problems facing the banks in 1987 and 1988, Norwegian financial institutions have come under increasing national and international scrutiny. Although the banking crisis of recent years is scarcely likely to have strengthened confidence in our financial institutions, I believe that the way the crisis has been tackled has strengthened confidence in our ability to deal with such situations. It has also been demonstrated that in order for the guarantee funds and Norges Bank to give support, the institution is itself required to implement the measures required by the situation. Terminating the operations of an institution in an orderly fashion is also an option which can never entirely be excluded.

The specificity of the banking sector

Stronger competition usually entails adjustment through squeezing the least efficient units out of the market. Notwithstanding the problems facing employees, the transition can be rather painless in manufacturing since current production can easily be taken over by a more efficient competitor. It is, however, more difficult to move a package of assets and outstanding credit than a flow of merchandise and payments. Consequently the effects of competition cannot be as easily accepted in the financial sector as in other sectors. Our legislation therefore recognizes the special position of financial institutions and this is reconfirmed in last year's legislation in this area. The strengthening of the Banking, Insurance and Securities Commission is an expression of the same attitude. What we see is both a commitment and a responsibility on the part of the authorities to actively promote the smooth functioning of the system. We must nevertheless be prepared to see other financial institutions scaling back or winding up their activities as a result of insufficient earnings. An important challenge will be to minimize the adverse effects of such events on the financial system and the society it is supposed to service.

With a view to 1992

Despite further substantial losses in 1989, we expect an improvement in net operating revenues for banks. This is indispensable if Norwegian banks are to be able to adapt to the new capital adequacy requirements by 1992 when the relevant agreement reached under the auspices of the BIS takes effect. These standards will also be applied in Norway. Those banks which operate internationally would in any case have to adhere to these rules and it would cause undesirable distortions in the market if they were not made general, at least after a transitional period. The new regulations would also improve risk assessment by financial institutions.

I presume that the various institutions have already started analysing the implications for operations and capital requirements. To expedite the process it is important that the authorities finalize their work on the new provisions as soon as possible.

Norges Bank has assessed the banks' capacity for meeting these new requirements. Any such assessment involves some uncertainty, and calculations that apply to the two bank groups collectively can conceal wide disparities among single banks. Nevertheless we have concluded that these requirements can be met, allowing the banks at the same time to undertake a moderate expansion of their lending, on condition that:

(i) losses gradually return to normal by 1992
(ii) the net interest margin is maintained at the end-1988 level over the next two years or so
(iii) equity capital can be raised through stock issues by commercial banks, and issuance of primary capital certificates by savings banks, in approximately the same proportion to retained profits as in the case of commercial banks prior to 1987.

We believe that these are realistic conditions that can be fulfilled.

If these conditions are not met, it does not mean that the banks will not comply with the capital requirements. That they will have to do. Instead, banks would have to scale back operations even further, with the resulting effects on the real economy.

A market for risk capital

An overriding economic policy objective is the renewal of growth in the exposed sectors of business and industry. Financial institutions, by virtue of their activities, should be in the best position as far as obtaining information and assessing the risk of investment projects are concerned. Extending credit on the basis of such assessment must therefore be their contribution to the adjustment process of Norwegian business and industry. But banks can supply business with loan capital, not risk capital. Risk capital must be raised by the owner and is more than an alternative to loan capital: it is the condition for being allowed to borrow.

Developments in recent years have revealed inadequate risk assessment by financial institutions and insufficient equity capital in the case of many investment projects. Loan capital has in many cases come to serve as risk capital. The costly experience of the 1980s should lead to a clear improvement in the years ahead. But if lending capacity is substantially curtailed as a result of a weak financial position, financial institutions will not have much room for making use of the experience gained.

The demand for equity capital from business and financial institutions will be considerable in the next few years. The shift to a more market-oriented monetary policy called for a higher return on investments and a higher share of equity capital in firms. When interest rates were low, the return requirements were low and it was profitable to finance investments as far as possible through borrowing. But in today's situation we cannot afford to invest in projects and industries with low return on capital.

A supply of equity capital will be required both for expansion and restructuring. This process must be supported by an efficient and liquid stock market and confidence that it will remain that way. The high profits which sometimes may be earned on investments on the stock market must be seen as a necessary compensation for the losses which are at other times incurred. For investors to accept such uncertainty, investments in stocks must be expected to pay a risk premium over and above the assets yielding a risk-free rate of return.

Seen over a longer period there is no indication that this risk premium has been particularly high. In the period 1968-1987 it averaged 3-5% compared to investments in the money market. The rate of return in the stock market has hardly been higher than the return on housing investment in the same period.

An expanded stock market with wider participation by both private and institutional investors should serve to dampen the impact of short-term fluctuations. But if the stock market is to be a source of capital, it must be possible to make a profit in it, and when this occurs we must avoid the possible temptation of tightening the reins again.

Changes in financial markets

Fluctuations in market shares between various groups of financial institutions will naturally occur in a competitive market. Previously such fluctuations were often caused by credit policy regulations. In the coming years factors such as efficiency and market adaptability will take precedence. The large and firmly established enterprises will to some extent replace bank credit with securities as a source of funds. Larger enterprises have found it less expensive to raise finances via the security market rather than banks, which has engendered the international securitization process we have seen in recent years. The loan certificate market is firmly established and will surely continue to expand. However, newly established firms and small businesses may find it harder to obtain access to these markets. Issuing of loan certificates and public subscriptions of new equity capital are largely reserved for larger and long-established companies. The banks should prove to be an appropriate source of counsel for business start-ups since they have extensive knowledge of local conditions through their branch networks. But they may also contribute by discouraging projects which are deemed inviable.

The new law on financing which was enacted last year provides the framework within which our financial institutions are supposed to work. As in other areas of economic life, the premise is that competition begets efficiency. As I already mentioned, this will imply a continuous pressure on financial institutions' net interest levels. The pace of technology and internationalization also implies that in the long run no group of institutions or single institution can shelter its earnings. The decisive factors determining which financial institutions will continue operations through the next decade are cost-effectiveness and expertise. The cost reduction measures now being taken must therefore not be limited to stop-gap measures but must be followed up by a continual, albeit less dramatic, process for improved efficiency.

The imminent reality of the EC's single market is another important momentum pulling in the same direction. Although the real effects on the Norwegian financial system have not been fully assessed, there is some indication that foreign financial institutions will have to receive greater latitude in Norway via freer entry for the establishment of branches and subsidiaries, and that competition for Norwegian institutions operating abroad will become even sharper. Norwegian financial institutions are however familiar with this situation. Foreign banks have been operating in Norway for several years without producing any unbearable competitive climate for our own banks. Norwegian financial institutions should be well-equipped to compete in EC markets, given their high technical standards and long experience in competitive markets, often surpassing that of banks in many EC member countries. The adjustment of their internal structure, forced upon them by the heavy cloud of losses, could prove to be a blessing in disguise.

The internationalization process could also eventually lead to a re-evaluation of certain aspects of our structural policy. The danger that merger into larger units in the Norwegian market might impede competition will be reduced if foreign financial institutions become an alternative.

However in this area, as in so many others, internationalization must start from a strong home base. Not all direct investments abroad have been crowned with success, and the risk becomes greater as the pace of expansion accelerates.

Ambitions and instruments

In the post-war period we have pursued a highly ambitious economic policy. Compared with other countries, our ambitions have been particularly high with regard to income distibution, regional policy and full employment. Recently environmental considerations have been added as a matter of compelling concern.

Whereas developments in 1970s and '80s forced other countries to reconsider their ambitions, oil revenues fuelled ours.

This time has come to an end and we have taken important steps to adapt to new realities. Although the fruits of our action are now discernible we must realize that the process is still in its infancy.

What remains is the fundamental question of how high we can set our sights. When our objectives can no longer be attained through use of oil revenues, other instruments are required. But such instruments regularly imply constraints on economic agents, generally enterprises and households. These constraints most often take the form of increased taxation and often regulations which invariably impose a burden on the economy. Moreover, experience tells us that such measures are far from failsafe in achieving our objectives.

Against this background, both our ambitions and our instruments need to be reassessed. If our ambitions outstrip our means, the difference will continue to be levied on our petroleum wealth. As I have shown, this option is on the way out. By failing to choose an appropriate scope for our ambitions, we are leaving the problem to our children and grandchildren. They will not have the same avenue of escape.

The year we have now entered offers us a great opportunity to choose our path for the future. But we may very easily take a wrong turn. Election year 1989 is not merely a time for choosing a government: it could well be a year of even more fundamental choices.