Economic Perspectives

Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 18 February 1988

In my annual speech this year I will concentrate on three topics: first, risks and challenges currently confronting **the international economy;** *second,* **financial balances** *in our domestic economy, with particular reference to the household sector. In this connection some international comparisons may be illuminating. Third, I will look at some recent, and prospective, developments in* **financial markets.**

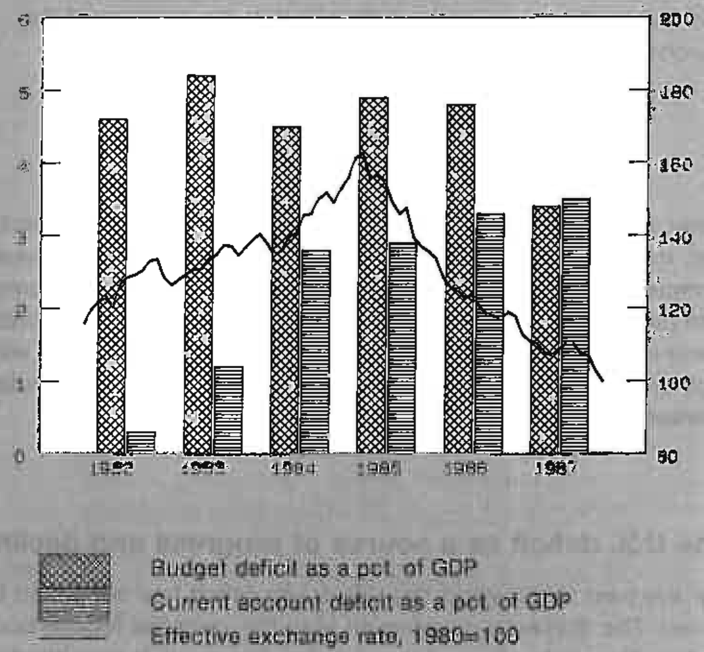
The U.S. deficit as a source of progress and decline

For the past seven years the U.S. trade deficit has continued to widen. The domestic counterpart is in the main the federal budget deficit. The United States' fiscal policy has made it possible for the country to maintain a strong and long-lasting economic expansion. Since the turnaround in 1982 the annual rate of growth has averaged close to 4 per cent, and unemployment has been reduced to less than 6 per cent, which is low by U.S. standards. At the same time, the potential for exports to the United States has provided an important boost to growth in other countries, which many have made the most of in rectifying their external economy. Most notably, however, a few countries – particularly West Germany, Japan and other Far Eastern countries – have increased their, already sizeable, export surpluses.

If this had been the end of the tale, it would all have been a huge success – almost too good to be true. But it continues unrelentingly, showing that success had been achieved on an unsound basis.

Ordinarily, an external deficit leads to a declining rate of exchange for the currency of the country in question. However, in the case of the United States a high interest rate level together with a less tangible confidence factor led the entire world to continue purchasing dollars. This resulted in a protracted rise in the dollar exchange rate despite the deficit. It became a task for international economic cooperation to bring down the dollar. Since this was a shared concern and the market gradually started to pull in the same direction, the Plaza meeting in the autumn of 1985 was crowned with notable success. The dollar fell, but in a controlled fashion, and when control was in danger of being lost a new summit agreement, this time the Louvre accord, resulted one year ago in a reasonable degree of exchange rate stability up to last autumn.

Chart 1.
U.S. Imbalances



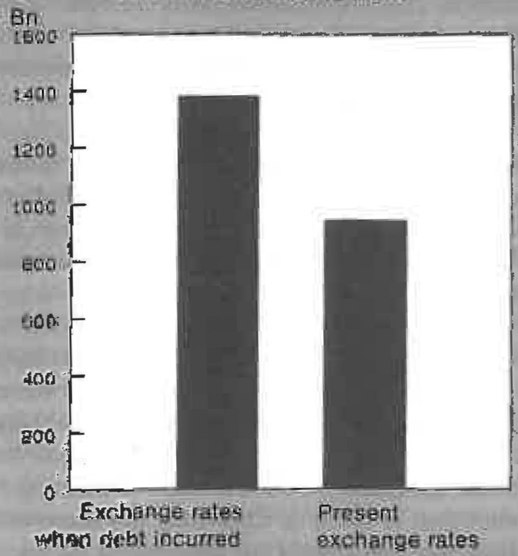
Large government budget deficits and a steep rise in the dollar exchange rate up to the beginning of 1985 are the main factors behind the large and in some respects growing U.S. external deficit. The expansionary fiscal policy led to substantial output growth both in the United States and the rest of the world. Naturally enough, the large supply of dollars created by the U.S. current account deficit led to a fall in the dollar exchange rate. Since early 1985 the dollar has shown a steadily falling trend despite increasing intervention by central banks. So far the fall in the value of the dollar has not led to a smaller U.S. current account deficit.

Source: OECD and IMF

However, by then the U.S. deficit was being financed from new sources. Whereas the Plaza meeting created the confidence necessary for private capital to move into the dollar, since the Louvre meeting a large part of the deficit has been financed by the major industrial countries' central banks through their interventions in support of the dollar.

Being able to use its own currency to finance the deficit is a privilege that only the United States enjoys. If the country had been compelled to finance its deficits in the 1980s using, for instance, the Deutsche mark, overall deficits reckoned according to the exchange rate applying in each individual year would have amounted to about DEM 1400 billion. However, the increase in net debt in the same period based on the present exchange rate amounts to a mere DEM 950 billion. Had similar calculations been made in Japanese yen, the difference would have been even greater. Since the United States' debt was founded in strong US dollars and is at present quoted in weak US dollars, a huge volume of real resources has in fact been transferred to the world's wealthiest industrial country.

Chart 2.
U.S. Net Debt Increase, 1982–1987, in Terms of the Deutsche Mark



A deficit on a country's current account means an increase in net external debt. If net debt is denominated in foreign currency, it will be affected by exchange rate changes. Unlike other countries, the United States can finance deficits with its own currency: thus, the fall in the dollar has not increased the country's net debt measured in dollars. On the other hand, countries which have financed the U.S. deficits have suffered considerable losses since dollar assets acquired when the dollar exchange rate was high, are now worth far less in terms of the domestic currency.

Source: OECD

Its absolute size also puts the United States in a special position. An external deficit of some 3.5 per cent of GDP, as was the case in 1986 and 1987, is no larger than that of many other countries, including Norway. Nor is a budget deficit between 3 and 5 per cent unusual in this context. However, the United States' current account deficit in the same years corresponds to almost a quarter of other OECD countries' saving, and because private saving in the United States is low, other countries' saving is used to finance the government's budget deficit. Accordingly, the deficit of the United States has far greater repercussions for the international economy than the deficit of any other country.

The emerging imbalances in the world economy in the 1980s have much in common with the situation which led to the breakdown of the Bretton Woods system in 1971. Today, however, the international monetary system is elastic to the point where there is little that can break down. Even so, the current problems could turn out to have severe adverse effects on the world economy.

World economy on a razor's edge

The fall in the dollar exchange rate since 1985 has led to vigorous growth in U.S. exports. The United States is once again a strong competitor on world markets. The deficit measured in real terms has also diminished. But because the dollar has concurrently weakened, the deficit in dollars has continued to grow.

U.S. adjustment so far has been chiefly left to the exchange rate, while demand and imports have continued to rise. Nonetheless, demand in other countries, particularly Japan, has grown at a stronger rate, providing an important contribution to reducing the imbalance.

Thus far, adjustment via the exchange rate has worked fairly well. However, the steep fall in the dollar last autumn may indicate that it is becoming increasingly difficult to sustain the necessary confidence in the dollar, and one may question how long central banks in other major industrial countries will continue to purchase dollars if their value is expected to decline. Economic development in the years immediately ahead will largely be determined by the response to this situation.

Chart 3.
U.S. Import Surplus.
First Quarter 1985 = 100

The U.S. import surplus has shown a clear reduction in the past year, measured in constant prices (or volume). However, in terms of current prices there has been no improvement. This is due to the fall in the dollar exchange rate, which has led to a relatively strong increase in import prices. The export price increase is far slower, for one thing because the domestic cost rise is very moderate despite the increase in import prices.

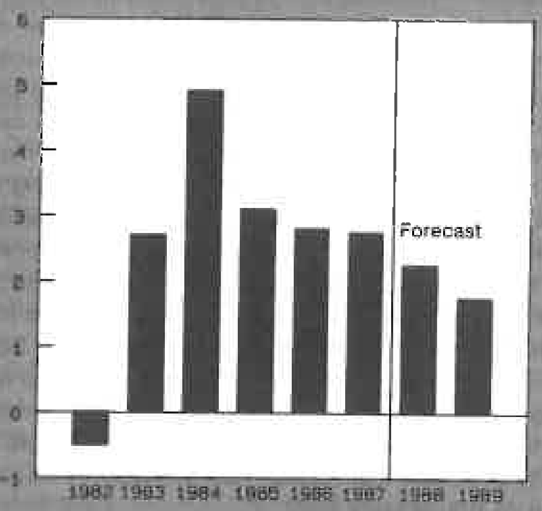
Source: OECD

If the solution is left to the market-place, experience indicates that the dollar may fall by a far larger margin than is required to regain satisfactory balance in the long term. The United States' chances of exploiting the fall in the dollar to improve its trade balance will be limited by the already high utilization of production capacity and manpower. Instead, the fall in the dollar may intensify inflation and interest rate increases. Balance will gradually be re-established through the resultant reduction in demand, but at a lower level of activity. In addition, interest rate increases will have added to the debt problems of developing countries.

In other countries investors will see the domestic value of their dollar assets diminish, and may try to compensate for this by increasing their savings. Moreover, export industries will suffer from the disappearance of export surpluses to the United States. This interaction of contractionary forces could lead to a fairly serious setback for the international economy.

The alternative is economic policy coordination among the main industrial countries to curb and control a fall of the dollar, combined with measures to stimulate demand in surplus countries. International forecasts are based largely on such assumptions, and it is quite possible that this approach can be carried through, especially since to some extent it is what has been done. However,

Chart 4.
GDP Growth in OECD Countries.
Per cent



The upswing in the world economy is now entering its sixth year. Lower growth is forecast for the current year and next year. Even so the forecasts are optimistic in the sense that they assume a coordination of economic policies to curb and control the fall in the dollar exchange rate, coupled with measures to stimulate demand in surplus countries. In the absence of such coordination, growth may well be lower.
Source: OECD

even on such favourable assumptions world economic growth in the forthcoming years is expected to be lower than hitherto.

It is to be hoped that the network of international cooperation established among governments and central banks will be strong enough to prevent a serious world recession. Cooperation between the major countries, be they three, five or seven is in this context of particular importance.

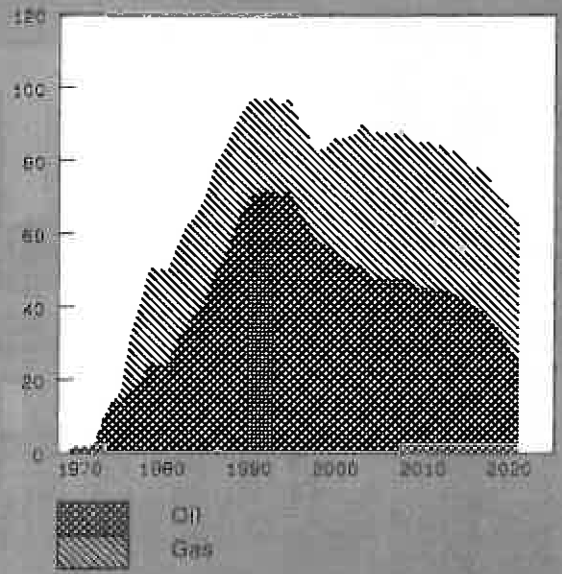
It is difficult to forecast precisely where in the area between economic setback and moderate growth the world economy will find itself in the next few years. What we can say with some certainty is that our own adjustment in the coming years will have to be carried out under more difficult international conditions than if we had continued the policy of moderation in domestic demand that we pursued during the years 1978–83 into the mid–80s and carried out the adjustment then.

Outlook not shaped by oil

As the Norwegian economy is more based on raw materials than most in our part of the world, we tend to base our scenarios for the future on assumptions and guesstimates about the price and quantity of the major commodities, particularly oil and gas. We have drawn rosy scenarios with high oil prices and had nightmare visions at the thought of low oil prices. However, if we extend our perspective somewhat further on in time we can reduce our dependence on these price assumptions and instead focus on two more fundamental facts. First, most of our currently known oil reserves will be depleted by the year 2000. Second, gas, of which we have far larger reserves, is more difficult to market, entailing less certainty of achieving balance between resources and sales than is the case for oil. Therefore, although the petroleum sector's contribution to the Norwegian economy will still be important, it is bound to decline in the foreseeable future. Should oil prices in the interim rise to a higher level than we in the current situation consider it prudent to expect, the revenue will be turned to good account in liquidating the debt which we will accumulate in the next few years. If prices should rise to a still higher level we will have a new opportunity to secure our future – as we ought to have done in the past when oil prices were high.

We can make forecasts for 1992, 1995 or other years, with different prospects for balance in the external economy, all according to our assumptions regarding prices and output of petroleum products. But it takes a long time to change the economic structure of a country. Our framework for economic policy must therefore be based on the non-oil economy as the mainstay of long-term economic development.

Chart 5.
Output of Oil and Gas.
Million TOE. 1971-2020



Production of oil and gas has risen sharply since 1980. Based on current development and production plans and known reserves, output will peak at the beginning of the 1990s and thereafter decline. This is specifically true for oil. Gas, of which we have larger reserves, is more difficult to sell. This increases the uncertainty about what contribution the petroleum activity can make to Norway's economy in the years ahead.
Source: Central Bureau of Statistics

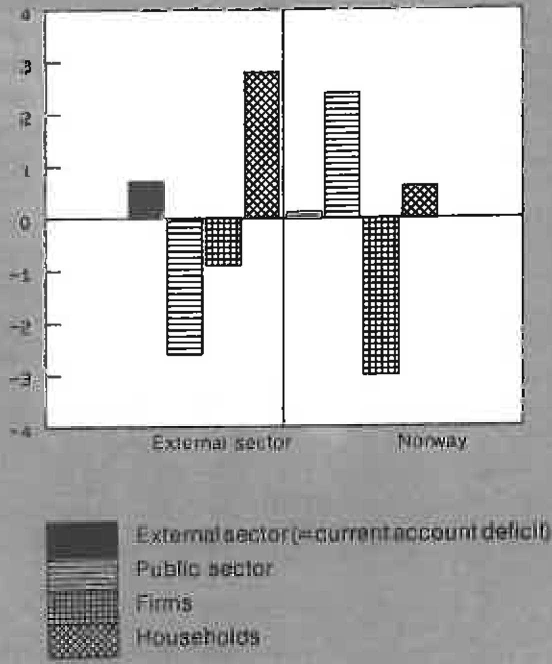
Saving, real investment and net financial investment

Our external deficit, excluding exports and imports of ships and platforms, currently amounts to about 5 per cent of domestic demand. «External deficit» means that our overall net financial investment is negative. If the external economy is in balance or in surplus, then financial investment must be nil or positive for Norway as a whole. In practice, balance is achieved when some Norwegian sectors show positive net financial investment which they deploy as assets with other sectors, which are then net borrowers. The domestic sectors in question are the public sector, households and firms. The external sector absorbs the sum of positive or negative financial investment of Norwegian sectors, but of course with the opposite sign.

A first step towards narrowing the current account deficit would be to single out the main domestic deficit sectors.

In most countries, households show positive financial investment which provides a basis for net lending to firms and the public sector. This is not the case in Norway. Here it is the central government that has a surplus which it channels to the business sector.

Chart 6.
Financial Investment in Norway and Internationally as a Percentage of GDP. 1977–1985



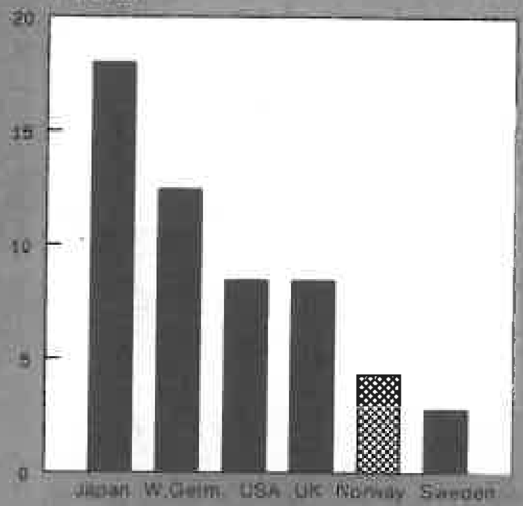
In most countries (represented here by the United States, Japan, the United Kingdom and Sweden) the household sector's positive and substantial financial investment makes up for the negative financial investment of firms and the public sector. In Norway, household financial investment has traditionally been very low, and it is the public sector which in the first instance has been responsible for making good firms' negative financial investment. Notably, firms' financial investment has been more negative in Norway than abroad.
Source: OECD and Norges Bank

Traditionally, households have been more or less in balance. In other words, households saved about enough to cover their own investment in real capital, the most important item of which is housing investments. Seen in relation to income, saving for housing purposes has been fairly high in Norway. In other countries a far greater share of housing construction is in the form of private apartment buildings for rent, with some housing construction under municipal auspices.

However, our predilection for owning our own home is not the only explanation for the household sector's traditionally low financial investment. This sector's overall saving as a share of disposable income has also been lower in Norway than in most other countries.

As a result, the financial position of Norwegian households is of course now weak. It is not easy to find comparable figures for assets and debt for different countries; however, households' inte-

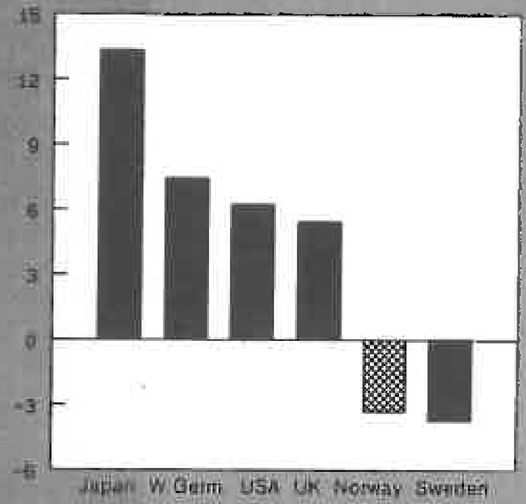
Chart 7.
Household Sector Saving Ratio.
Average 1977–1985.
Per Cent



Between 1977 and 1985 the Norwegian household sector's saving ratio averaged about 4 percentage points. This is very low by international standards. In most countries the saving ratio is double the figure for Norway. However, household saving was also low among neighbouring countries, especially Sweden, where it averaged less than in Norway.

Source: OECD

Chart 8.
Net Interest Income in Per Cent of Disposable Income.
Households, 1985



Households' net interest income (interest income less interest expenses) is in most countries positive and in some countries, e.g. the United States, it represents a major source of income. In the Nordic countries, where interest expenditure exceeds interest income, producing a negative net interest position, the opposite is the case.

Source: OECD

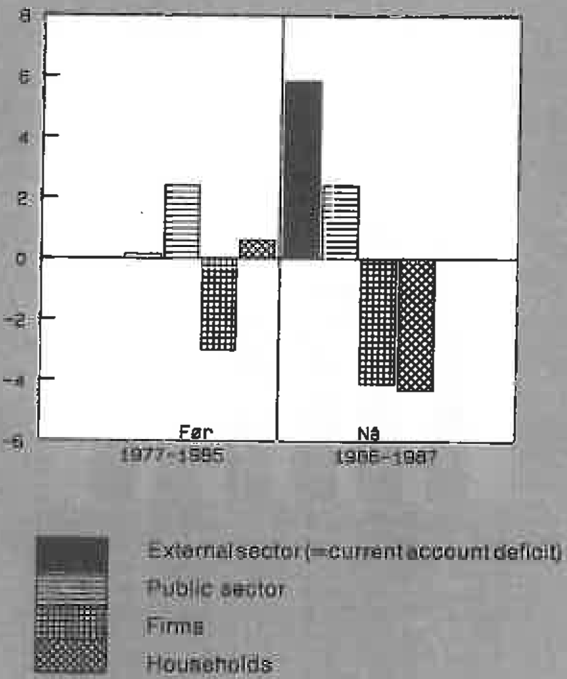
rest income and expenditure as a percentage of disposable income is perhaps illustrative.

In most countries interest income, both gross and net, is a substantial source of income for households. In Norway, on the other hand, as in neighbouring countries, interest expenditure exceeds interest income. This may explain why an interest rate increase appears to generate emotions on a scale quite different from that in countries where households profit by higher interest rates.

As long as households were in approximate financial balance and central government showed positive financial investment, Norway was in surplus or reasonable balance vis-à-vis abroad. This pattern also prevailed prior to the oil era. However, in 1985 household saving turned negative, and in 1986 deteriorated. With real investment at approximately the same level as previously, financial investment became even more negative. Some ground was recovered in 1987, and we expect this to continue in 1988, but a return to the pre–1985 situation is still a long way off.

Norway is not alone with its steep increase in household debt; other countries share the same concern. However, in 1985 we accelerated away from this internationally rising trend. I will not

Chart 9.
Financial Investment in Norway
In Per Cent of GDP



The sectoral distribution of financial investment in Norway in the period 1977–1985 was rather unusual; see chart 6. Nonetheless, the balance of payments was in approximate equilibrium, i.e. Norway's overall investment was close to nil. In 1986 and 1987 a serious imbalance arose, primarily as a result of a dramatic reduction in household financial investment. Unless this is rectified we will not succeed in removing the current account deficit.

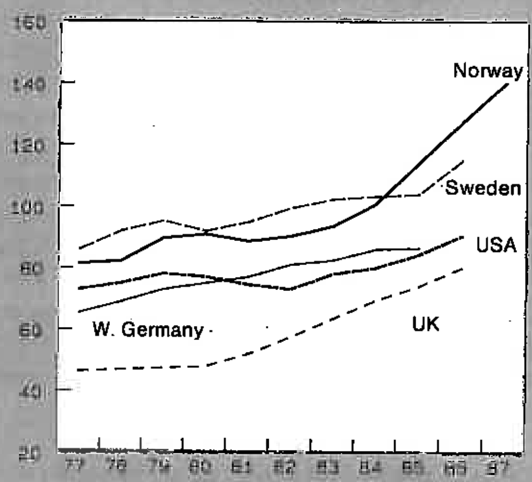
Source: Norges Bank

here resume the discussion of how far this was due to the removal of financial market regulation, or to the fact that we allowed borrowing costs to remain too low or to other factors. At all events the outcome was that while in 1984 the household sector's gross debt was roughly on a par with income, in 1987 it was almost 40 per cent higher.

Of the country's net debt increase[1] of 60 billion kroner in 1986 and 1987, the increase in household net debt accounted for 55 billion kroner. In other words, our external deficit would have been manageable had the household sector been in financial balance, as in 1983–84. Hence, a main objective of the adjustment process should be to bring the household asset-liability ratio back to its traditional level. Preferably, the household sector should be in a position to supply business and industry with the capital it will need to carry out necessary structural changes.

[1] Excl. the effect of exchange rate changes.

Chart 10.
Household Sector's Gross Debt in Per Cent of Disposable Income



The tendency of households' gross debt to increase more strongly than their income is familiar internationally. Between 1984 and 1987 Norway marked itself out with far stronger growth in gross debt than in other countries. Whereas gross debt more or less equalled disposable income in 1984, in 1987 it exceeded income by 40 per cent.
Source: BIS, National Institute of Economic Research, Stockholm, and Norges Bank

Why won't Norwegians save?

We can approach this problem by asking two questions. First, why is household sector financial investment so low, and second, why is it so much lower than in other countries? These questions have to some extent a common answer, and we can therefore deal with them as one.

A useful method when seeking to explain economic issues is to assume that people behave rationally according to their own interests. As will be seen, we may not have to look any further for an explanation of low savings.

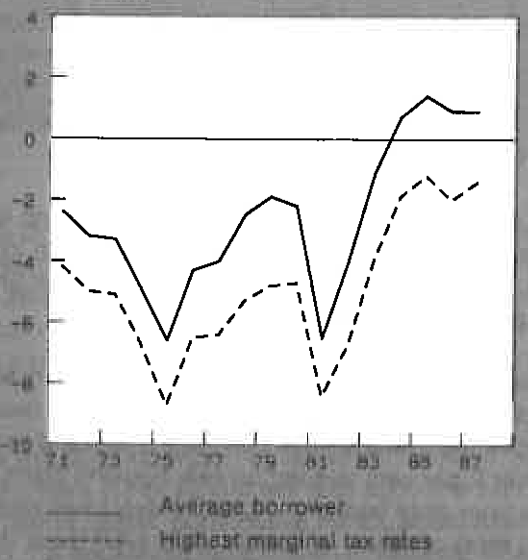
Real after-tax interest rates were negative for the great majority of households right up to 1984 and, even after they became positive last year, to the average bank borrower amounted to no more than a little over 2 per cent interest on new housing loans. Interest rates on loans from state banks and credit enterprises were lower. Real, after-tax, rates of return on assets were even lower in this period but, for those who do a little market research before placing their money, they have in recent years turned slightly positive. In fact, against this background, positive household sector financial investments of some magnitude would have required an explanation. The long period with negative real interest rates after tax is bound to have shaped peoples' attitudes and to persist for some time even when this situation no longer applies.

Tax treatment of interest expenses

We all know that the deductibility of interest payments for the assessment of taxable income combined with taxation of income receipts is a major reason for the conditions described above. In recent years action has been taken to remedy the situation, first by lowering marginal tax rates in general, and in the past two years by establishing the distinction between tax on gross income and on net income. The latter move has had some impact on the highest income groups, but not much on the average borrower. The trend has probably been much the same in the case of the average asset-holder. Tax treatment of interest payments varies so widely from country to country that it is difficult to obtain a true picture of real borrowing costs in different countries. However, although there is some doubt as to the exact figures, it is possible to obtain a fairly well-founded impression of Norway's position relative to other countries.

Norway is one of the few countries where interest payments on consumer loans are tax-deductible. Real after-tax interest rates on such loans are therefore lower than in most other countries. A far greater number of countries allow some form of tax relief on housing loans, making a comparison in that area more difficult. Yet, there is no doubt that Norway has distinctly lower interest rates on housing loans than the vast majority of countries. Sweden, which employs a system that gives tax rebates on about the same scale

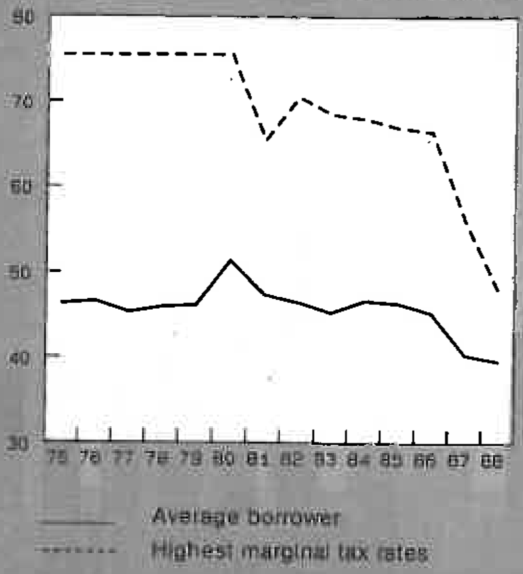
Chart 11.
Real After-Tax Interest Rates.
Per Cent



Real after-tax rates of interest for the average borrower were negative right up to 1984, and in recent years have barely exceeded nil. For borrowers with the highest rate of marginal tax, real after-tax interest rates have been negative in the entire period 1971–1987 despite their substantial rise in the 1980s.

Source: Norges Bank

Chart 12.
Marginal Rates of Tax on Interest on Loans. Per Cent



The marginal rate of tax on interest on loans for the average borrower was fairly stable at around 45 per cent right up to 1986. From 1986 to 1987 the marginal rate of tax was reduced by about 5 percentage points as a result of greater emphasis on tax on gross income. Continuation of this process in 1988 had a very moderate impact on the average borrower. On the other hand, the highest rate of marginal tax on interest on loans was sharply reduced both in 1987 and 1988: the overall reduction is 16.4 percentage points, and the highest marginal tax rate is now 48 per cent.

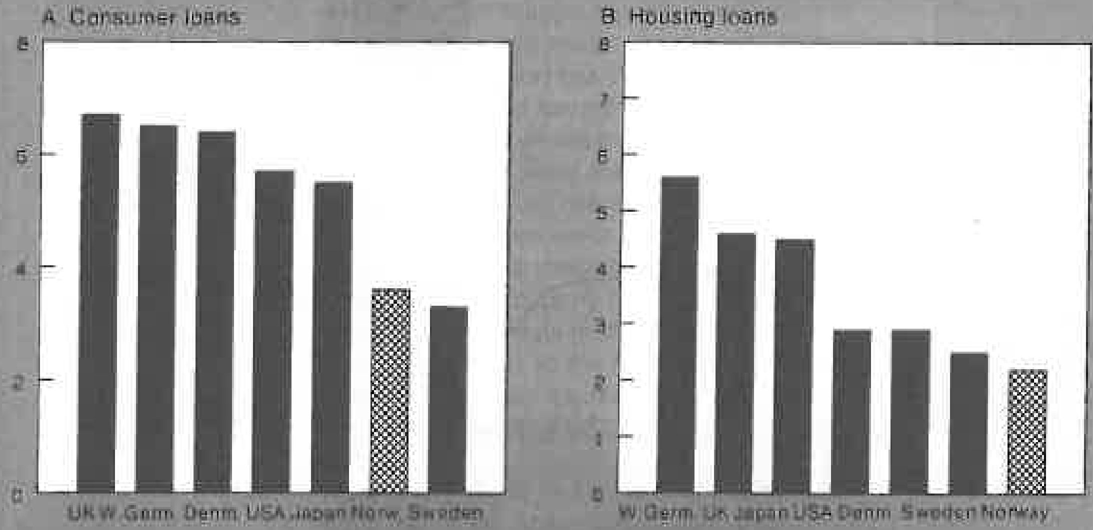
Source: Norges Bank

on both consumer loans and housing loans, is struggling with the same kind of problems as ourselves.

However, Norwegian households hardly feel as poor as they might seem on paper. In recent years the housing stock has increased steeply in value, thus reducing the need to increase wealth through saving. Both the increased interest rate level and the increased level of housing prices are a result of inflation. For the home owner, the inflation reduces the real value of debt, thereby increasing real wealth. At the same time he must pay for the increase in wealth through the higher interest rate level. In a sense, this entails a form of saving. Nonetheless, the borrower protests since saving has to be paid for out of current income.

Poor real rates of return on financial investment and low real borrowing costs probably provide an adequate explanation for household sector behaviour. In addition, the necessity of accumulating assets to meet particular needs has traditionally been a motivating factor; saving for a home, for children's education and for old age were previously important incentives. Saving for a home probably

Chart 13.
Real After-Tax Interest Rates



Real after-tax interest rates are very low in Norway, both on consumer and housing loans, chiefly because of the tax treatment of interest expenses. Few countries, and none of the major OECD countries, allow interest payments on consumer loans to be deducted for income tax purposes. Where loans for housing purposes are concerned, the picture is somewhat more complicated; however, here too, real after-tax interest rates are lower in Norway than in most other countries. The charts refer to the autumn of 1987.

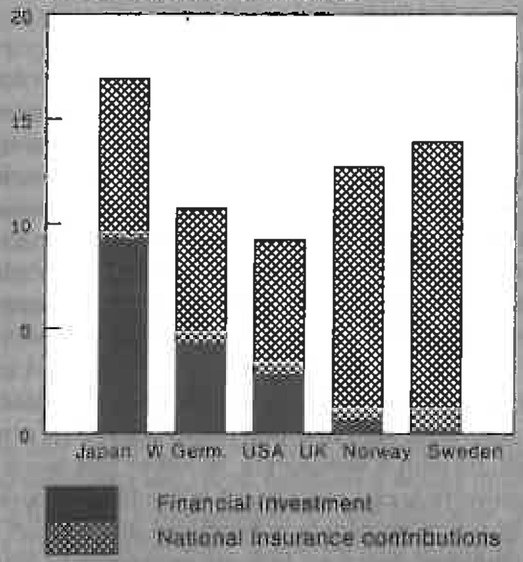
Source: Norges Bank

remained important so long as it was necessary to provide some non-borrowed funds. Well into the 1980s household debt growth was restrained despite negative real after-tax interest. This is explained by the quantitative regulation of credits which made saving in advance necessary. With deregulation of credit markets, saving requirements are relaxed and instalment credit expands. This will reduce financial investment in the transitional period. Saving for education has largely been rendered superfluous, and expansion of the social security system has lessened the need to save for old age. In general, easier access to loans has lessened the need to put aside funds for a rainy day. And those who haven't believed in such days have felt even less need to save.

Many of these long-term trends are international and therefore fail to explain why the Norwegian household sector's level of saving is lower than that of other countries.

However, the impact of the social security system can be assessed by examining national insurance contributions and households' financial investment in some countries as a percentage of gross domestic product. The connection is not unequivocal, but there does appear to be tendency for a highly developed social security system to coincide with low financial investment by the household sector. This is not entirely surprising.

Chart 14.
Financial Investment and National Insurance Contributions, Household Sector.
Per Cent of GDP. 1977–1985



One likely reason for the very low level of household sector financial investment in Norway and Sweden is the highly developed social security system in the two countries. This is to some extent illustrated in the chart which shows the relative proportions of household financial investment and household national insurance contributions in several countries. Whereas in Norway and Sweden, the need to secure incomes is met by the social security system, in other countries this need is met by a higher level of saving.

Source: OECD and Norges Bank

Can we influence saving behaviour?

Our chances of rebalancing the Norwegian economy, both in the short and long term, will to a large extent depend on household saving behaviour. What can we expect, and what can we do?

If progress is to be made, we must raise both the real cost of borrowing and the real rate of return on assets. In this context the tax treatment of interest receipts and expenses is just as important as the interest rate itself. So far we have been much more concerned with equalizing the tax advantage for various income groups than with reducing it. There are certainly good reasons for minimizing the discriminatory aspects of the system. However, for the overall economy it is more important to consider what bearing these aspects the tax system have on average-income households. After all, they make up the bulk of the populace and, if results are to be achieved, there can be no question of their being spared the effects of changes in the system.

The international price of capital currently corresponds to a real interest rate of 4–5 per cent. This is what it costs Norway to borrow. If the domestic real cost of capital is lower than that prevailing on the international market, this entails some form or other of subsidization of the domestic borrower. Rebalancing our economy will be a difficult and costly process unless we manage to put an end to this form of subsidization.

In view of their debt burden, households should in time be expected to increase their financial investment. Indeed, this process seems to have started, but for the time being is confined to fewer car purchases. Borrowing for other purposes appears to be continuing. The household sector's increased interest burden is to a far greater degree due to increased debt than to a higher interest rate level. Thus, despite the vehement complaints about the interest rate level, households continue to consider borrowing to be in their best interest.

Nonetheless, at some point a turnaround is inevitable, and though we have seen little sign of it this could mean that when it does come it will be with a vengeance. Whether that alone will bring about positive financial investment is doubtful. A barely positive real rate of return on assets is hardly an incentive. A change in credit institutions' policy as regards expansion of lending and market shares may prove to have a greater impact.

In Norway, as in other countries, the ratio of old age pensioners to the economically active population will rise in the period ahead. In time the bulk of those entitled to social insurance will have accumulated full supplementary pension rights. Rising average pensions and an increasing proportion of old people will place an enormous burden on the social security system. Any further extension of social security entitlements will intensify the problem. In the years ahead we will probably cope, but after the turn of the century our children and grandchildren will face a tremendous burden. Now is the time to draw up the plans for the social security system they will be shouldering. If the individual were given greater responsibility for ensuring his or her own pension beyond a socially acceptable minimum, this would both reduce the taxes our descendants will have to pay and provide a significant incentive for private financial investment in the coming years. Lowering the retirement age or widening the opportunity of accumulating supplementary pension rights will make it even more imperative to limit the individual's social security entitlement and instead introduce a greater degree of private financing of pensions.

A difficult year for banks

The credit system's task is to bring together savers and investors to optimize capital allocation. Last year's loss figures may give the impression that banks have not met this challenge in a convincing way. Nevertheless, their results are more easily accounted for in a long-term perspective.

By the time deregulation of bank lending was implemented, regulatory measures had lost much of their effect, and the economic upswing was already under way. It was fuelled by increased petroleum activity and an expansionary fiscal policy, and the growing demand for credit was offset neither by increased interest rates nor by a tightening of tax rules. Competition among banks and between banks and other loan institutions was sharpened and it mostly took the form of easier credit availability. Moreover, the price of delegating decision-making authority within individual banks was weaker control of lending. The strong increase in domestic demand gave erroneous signals of long-term profitability to the business sector and the credit system. In view of these factors it is not difficult to understand why losses were unavoidable when changes took place in the economic landscape. Stock market losses compounded the problem although their effect is more transitional and they followed previously earned profits.

Norges Bank warned against what we called aggressive marketing of loans to personal customers, both because it would intensify the cyclical upturn and out of consideration for this customer group. Indeed, losses appear heavier than is appropriate for loans which should really entail very little risk. However, they do not figure prominently in the overall loss context.

It is only reasonable that criticism be levelled at the banks for losses on projects which have been given negative media exposure; but nor has this affected figures to any great extent. Losses were mainly incurred in areas whose development was generally desired, not least for regional policy reasons. Even so, much of the losses incurred were related to the excessive growth of consumption. Yet the scale of losses in areas officially designated as growth industries is striking. There is no redress for exaggerated expectations, inadequate equity capital or poor expertise. It is not enough for an objective to be laudable: it must also be well-founded.

It would be both natural and appropriate for the banks to exercise greater caution after this experience. However, it could be detrimental if they went to the other extreme, making it impossible to finance risk-bearing projects. Generally, exposed industries' entry into less traditional sectors involves a certain amount of risk. The same applies to business start-ups. However, successful diversification will be crucial to sustaining employment and future growth in a balanced economy.

It is also worth underlining that although some banks have been harder hit than others, there is no banking crisis as such. The Banking, Insurance and Securities Commission ensures that financial institutions meet the statutory capital adequacy requirements, and guarantee funds provide depositors with added safety. However, should individual financial institutions find themselves in a position which could affect general confidence in the credit market, Norges Bank — cognizant of its responsibility as the central bank — is prepared to take such measures as are necessary to bolster market confidence in our financial system. The fact that Norges Bank provides loans to the banking system without any special security further contributes to securing the banks' other creditors.

A financial system undergoing change

If we look beyond today's situation, what trends do we discern in financial markets and how should we react?

Historically, banks had a distinctive position in credit markets since they had wider access to information than others. The banks knew best where capital could be raised, what it cost, where it could be invested and at what rate of return. They also had the best information as regards the borrower's position. We are now on the way to a society where information regarding money and market conditions is available on screens located in all firms with a somewhat developed financial administration. This gives lender and borrower easy access to each other on the certificate and bond markets, and reduces their dependence on banks. For this reason alone there is little point in any form of direct credit regulation via banks or other credit institutions. Attempts in this direction will merely serve to accelerate the trend towards less credit being mediated through these institutions. Rating agencies have existed in the United States for quite some time which provide borrowers with publicly known quality ratings. Similar agencies are emerging in Europe and there is nothing to prevent them from becoming established on a national basis for domestic markets.

Greater diversity in financial markets does not mean that banks will be in want of functions. Most borrowers will still neither wish, nor be in a position, to go directly to the market. And the public will still need the banks' services for both sound investments and payment transactions. Furthermore, when a loan is raised directly in the market the banks will be needed to ensure some degree of liquidity for securities and to guarantee safety. Nevertheless these functions do not provide any practical scope for the authorities to effect quantitative regulation. Borrowers and lenders will always find loopholes or simply circumvent regulations.

Furthermore, banks will always have the function of mediating payments transactions in such a way that both partners obtain maximum guarantee of correct settlement. In international settlements they also contribute by ensuring the customer that payments are effectuated at optimal exchange rates. This provides the basis for trade in foreign exchange many times larger in volume than the underlying payments.

The credit system also accommodates other financial services, and in particular insurance. We have traditionally maintained a dividing line between the various institutions. To what extent and in what way such a dividing line should be retained is under review. Most important, perhaps, is to ensure the necessary dividing line between the financial sector and non-financial sector.

No diminution of the authorities' role

As business enterprises, credit institutions occupy a special position. General economic activity is much more dependent on how credit institutions function than on any other single sector of society. Therefore the authorities play a more central role vis-à-vis financial institutions than other sectors. Their task is not reduced by the removal of quantitative regulation. Their function is to ensure that the system works as efficiently as possible, inter alia via competition in the market, by ensuring stability in the financial system and by influencing the total credit supply.

The objective of the proposals set out in parliamentary bill no. 41 is to promote competition through making conditions as fair as possible. It is not an easy task to make conditions equal among such disparate institutions. For example, equal capital adequacy requirements may not have equal impact. Capital adequacy requirements based on the risk associated with the composition of assets can provide a better result and furthermore give a truer picture of the real need for reserves.

The system is all the more effective when banks and other institutions are neither permitted nor encouraged to burden the interest margin with the cost of services they provide. The authorities responsible for credit policy have always supported the idea that services should be paid for by the user, and this support must also be given to individual measures implemented on the basis of this principle. No consumer interests are served by bullying the banks into operating in a non-rational manner.

The authorities' involvement will consist in particular of securing the stability of the system. This task will be more exacting in a deregulated market where profit margins are hard-pressed. We have already witnessed how competition has increased the temptation to take a lax view of risk assessment. The banks have presumably learned their lesson, and it is too late to remedy what has already happened. The experience should nevertheless serve as a reminder of the necessity of supervisory bodies monitoring the practice and routines of credit assessment. But stricter practices will also require acceptance of a bank's refusal or termination of a loan.

However, as I mentioned earlier the credit system must function in a way that enables it to take risks and sustain losses. This means that its earnings must be sufficient to build up funds and to service the capital raised in the market. In this respect, recent developments give no reason for comfort, even when we disregard last year's losses. Up to end-August 1987, commercial banks offset lower net interest revenues through profits earned on currency and share trading, but this came to a grinding halt.

If we establish a suitable framework for competition, we should be confident that interest margins will not rise higher than necessary. Any other form of control of lending rates would be both unnecessary and detrimental, and, in all likelihood, impracticable.

No getting round the interest rate

When the authorities are no longer in a position to influence overall credit supply over the private financial market with the help of quantitative regulations, they must turn to the interest rate. The force with which this instrument has to be used depends on the extent to which fiscal policy influences demand, how strong the cost pressure is and how much of the interest rate burden is assumed by the public authorities through tax reliefs. The weaker fiscal policy is, the higher inflation we get, and the more lenient tax rules are, the higher interest rates will have to be.

But let us not overestimate the precision with which we can apply the interest rate as a policy instrument. It is difficult to judge both the strength and the timing of the effects on demand of an increase in interest rates. We know more about the distributional effect, which the Interest Rate Commission showed was more or less neutral vis-à-vis major groups of income earners. The effects upon enterprises and households will to a large extent depend on the tax rules that apply to these two groups, and I assume that these effects will be examined by the commission which is currently reviewing credit policy management. Whatever the findings, the point is that we have no choice. If we want to influence the supply of credit, we have to use the price of credit.

The overall interest rate level will be determined by the credit and foreign exchange policy drawn up by the government with a view to balancing our country's economy. Norges Bank's interest on loans to banks reflects this policy.

If we are to achieve the desired effect, the interest rate level set by the authorities must be reflected in lending rates of credit institutions. Some departures from this principle can be maintained in specific areas for a limited period. But in the long run even home-buyers cannot be spared changes in the general interest rate level. It is left to the credit institutions, and in particular the banks, to meet the public on behalf of the authorities. Their task should not be made unduly complicated by creating unrealistic expectations of their scope for blunting the effects on borrowers of the interest rate level required to balance the economy.

The bumpy road towards balance

The adjustment of our real economy is two-sided. One side is curtailment of domestic demand to a level which is commensurate with the country's income. The other is to replace the resultant decrease in domestic demand by exports, or by purchasing less of what we consume from abroad and more from domestic industry. The extent to which we succeed will be decisive for the level of employment we can sustain.

Experience from other countries shows that this is not an easy process. Spending will have to be adjusted to income at some point, but this new stability is frequently achieved at a lower level of activity with higher unemployment. Denmark and Sweden are two examples of successful economic adjustment over a relatively short period of time, i.e. 4—5 years, without a permanent increase in unemployment. There were two preconditions for this: The international economic climate was favourable, and there was enough idle capacity in a diversified industry to absorb the resources released. However, adjustment also required fairly tough measures.

In Sweden, hourly earnings after tax decreased by 10 per cent from 1981 to 1983, and growth in public consumption was limited to roughly 1 per cent yearly up to 1986. In Denmark the authorities intervened in wage settlements through special legislation and the average wage earner's real disposable income was reduced by 5 per cent from 1982 to 1986, after a decrease of more than 10 per cent over preceding years. In both countries the current account deficit was relatively smaller than in Norway at present, but because they had waited too long before implementing stabilization measures, their external debt was larger.

We could mention similar examples in other countries, many of which suffered much higher unemployment levels. However, sustaining employment on the basis of a continued deficit was simply not a viable alternative.

Norway is less fortunate than her neighbours with regard to the preconditions I referred to. As already stated, it is more than doubtful that international developments will provide much support to our adjustment policy. We have little idle capacity and a rather one-sided economy. Our strength is the surplus in public finances. But, with a lower level of activity, fiscal policy will come under pressure, and a firm stand will be needed to maintain our strength in this area.

Over two years have passed since the decline in oil prices and since we decided that the party was over. How far have we come in curbing the factors that determine demand and demand itself?

We have on average maintained our real disposable income despite the reduction in working hours. Any substantial decline in 1988 is most unlikely.

The public sector has increased its spending on goods and services by a good 7 per cent, and some increase must also be expected in 1988.

Housing construction is being maintained at a high level, and business investment, excluding oil and shipping, has shown continued growth to date.

From 1985 to 1987 our relative cost level increased by 4 1/2 per cent, and the trend is continuing. This is hardly promising for activity in the exposed sectors.

Generally, we can say that we have not made great strides towards balance in the Norwegian economy – a balance that we in principle agree should be attained as soon as possible.

Even so, we are under the impression that we have pursued a contractionary policy with high interest rates, increased taxes, tight budgets and zero income settlements on a general level in 1987. But a stabilization policy involves more than not yielding to every group's demands.

Small steps or one big leap?

A stabilization programme can either be based on adjustment in small steps or across-the-board measures which are implemented simultaneously and which cover all areas of the economy. With a moderate external debt, ample exchange reserves and favourable loan terms, it is logical to choose the first alternative, and this is what we have done. The across-the-board method, or the leap, is most often opted for only when there is no other option.

But it is by no means certain that step-by-step adjustment gives the best result for the economy. One difficulty is that economic agents will have only limited information on the economic framework they can expect in the future. This creates uncertainty and misguided investment decisions. Another problem is that expectations of continued restrictive measures will adversely affect investment and innovation for some time.

Even more important, however, are problems in connection with political implementation of the adjustments. Various groups demand that the balance among them be maintained at each stage of the process, which compounds the problems which we would have to face anyway in designing a policy programme. Moreover, it is difficult to maintain a crisis awareness over an extended period, both in political circles and among the general public. After some time one experiences what is nowadays called «adjustment fatigue». The least sign of headway in the programme invites relaxation. Moreover, every other year there are elections, where a long-term stabilization plan is a born loser.

By now, we would probably have progressed further and in a few years been better off, if it had been possible to adopt a comprehensive stabilization programme as soon as it became clear that we had to adjust to lower oil revenues. We still have time to adopt such a programme, and one day this course may be the only one open to us.