Economic Perspectives

Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 12 February 1987

When I had the privilege of speaking to this assembly one year ago, the fall in oil prices was still a relatively recent event and the need to focus on a new reality had begun to dawn upon us. I tried to demonstrate that even the old realities would have required a reorientation of policy, but that the new situation had amplified the need and made it more urgent.

During the past year there has actually been a shift in policy – partly brought about by political decisions and partly forced upon us by the situation. The latter is particularly true of credit policy where I think we have passed a crossroads. This is also Norges Bank's most important sphere of responsibility, and it would therefore appear natural in this situation to look more closely at experiences gained and the possibilities open to us in this field.

The medium-term prospects for our economy, which I outlined one year ago, were based on certain assumptions concerning components of real demand of the various sectors. Today I will try to shed light on what these assumptions entail for these sectors' financial position and evaluate the outlook from this point of view. Against this background, I will conclude by pointing to some of the possibilities and challenges confronting us.

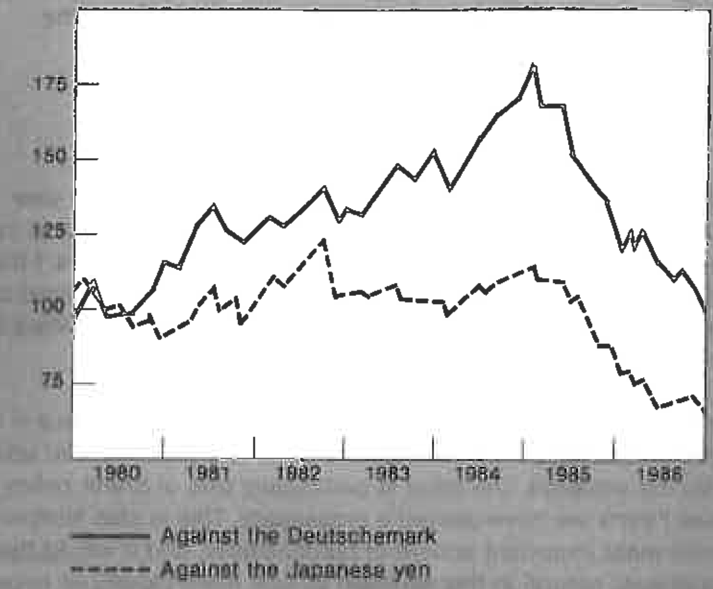
As was the case last year, the annual address is a result of efforts on the part of many people in Norges Bank, where I have also benefited from discussions in the Executive Board. However, as prefaces usually state, I alone am responsible for any errors and deficiencies.

I shall largely restrict my comments to the domestic arena, where one may hope that the annual address might be of some significance. It is nevertheless natural to start by outlining some of the main features of the international economy of which we are part.

Tensions in the international economy

The upturn in the industrialized countries is now in its fifth year. This is an unusually long time. Previous upswings have often been halted by measures aimed at reducing a rising rate of inflation. This time, the fall in the price of raw materials – especially oil – along with decelerating domestic cost pressures has brought the rise in prices down to less than 3 per cent. Even though inflation may pick up slightly in the period ahead, efforts to contain it are hardly likely to pose a real threat to a continued moderate upturn.

Chart 1
Exchange-rate development of the U.S. dollar.
Index: 1980=100



Since peaking in February 1985, the dollar exchange rate has declined by over 40 per cent against the Deutschemark and the Japanese yen. In terms of the mark, the dollar is now back to its 1980 level; against the yen it is now 20 per cent weaker than in 1980. The decline of the dollar in the past two years has, however, been substantially smaller vis-à-vis a number of other currencies, notably those of Canada and the newly industrialized countries in Asia.
Source: OECD.

But there are other tensions in the world economy. The U.S. current account deficit along with corresponding surpluses concentrated on just a few other countries is one such fundamental imbalance. The exchange rate shifts we have seen between the main currencies were therefore called for. The fall in the dollar exchange rate has been quite substantial (chart 1). Up to a few weeks ago at any rate it took place in a rather orderly manner, without creating major difficulties for world trade. This is perhaps not surprising inasmuch as we thus far have not registered any significant improvement in the U.S. balance of payments.

A fall in the dollar alone does not appear sufficient to alter the fundamental imbalance. Calculations by the International Monetary Fund show that with the real exchange rates which prevailed last autumn, the foreign debt of the United States would continue to grow and reach 14 per cent of GNP in 1991. The subsequent dollar decline may have altered the picture somewhat, but hardly in any decisive way. For the world's largest economic entity this is extremely high, and the question is whether the rest of the world is willing to send its savings to the United States to such an extent. For the United States it implies not only that imports and exports must be brought into balance, but, additionally the necessity of exporting to cover the interest payments on the foreign debt.

In order to correct this imbalance in the international economy, domestic demand growth must be lower in the United States than in other countries. A reduction in the federal budget deficit will contribute to this, but will at the same time reduce Norway's and other countries' potential for exporting to the U.S. It is crucial that the shift in demand which must take place between the U.S. and other countries is such that the increase in demand in surplus countries is greater than the reduction in the U.S.

As a whole Western Europe has solved its inflation problem, and at the same time maintained a balanced external economy, through measures which have resulted in high unemployment. This has remained at about 11 per cent in spite of a steady growth in production for several years. If stronger growth is to reduce unemployment without rekindling inflation, there must be less rigidity in the labour market. Even so, it is a question of how much can be achieved. A segregation seems to have developed between the employed and the unemployed with the result that high unemployment has little effect on wage and income formation. At the same time, technical capacity utilization is high so that increased demand will easily result in greater inflation without bringing any substantial decline in unemployment.

The debt problem of the developing countries is also one aspect of an imbalanced world economy. The past year saw examples where, vis-à-vis some countries, the IMF attempted to cope with the problem through a policy which places less one-sided emphasis on demand restriction. All the same, the international debt problem does not seem to have moved closer to a solution.

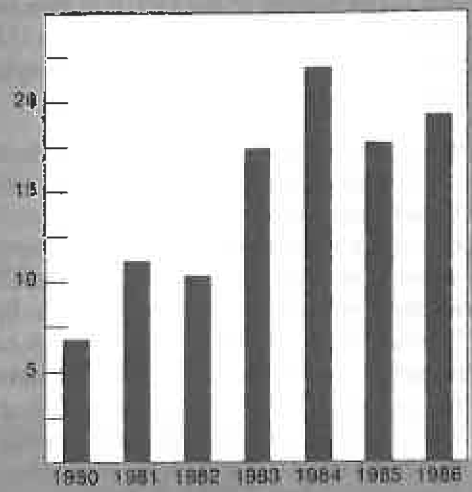
The imbalance in the world economy could be just as great a threat to sustainable growth as were previous periods of inflation. An increase in output in our markets of 2–2½ per cent during the next few years must, under these conditions, be considered a rather optimistic estimate. Historically, this represents a rather moderate expansionary stimulus, and if we are to exploit it we must adapt to a world in which the growth in unit labour costs is 2–3 per cent. Since, moreover, we can no longer base ourselves on the driving forces which sustained our economy through recent years, it is obvious that we are confronted with very demanding tasks.

The driving forces behind the expansion

The cyclical upturn from 1983 to 1986 was impelled by the international economy, petroleum activities, fiscal policy and credit developments.

The spillover effects of the international recovery were of a normal magnitude. From 1982 to 1983 traditional merchandise exports posted gains of nearly 10 per cent – on a par with previous experiences. An export-led upturn has a rather fast stimulatory effect on manufacturing investments. These expanded by an average 20 per cent a year from 1983 to 1986 and made a normal contribution to the growth in domestic demand compared with earlier periods of recovery.

Chart 2
Accrued investments in oil and gas production and pipeline transport. Billion kroner, 1980 prices



The investment growth in the oil sector is an important factor behind the particularly strong economic upswing in Norway in the last few years. Accrued investments in the oil sector increased by 75 per cent between 1982 and 1986, and have by far surpassed overall manufacturing investments in the past few years.

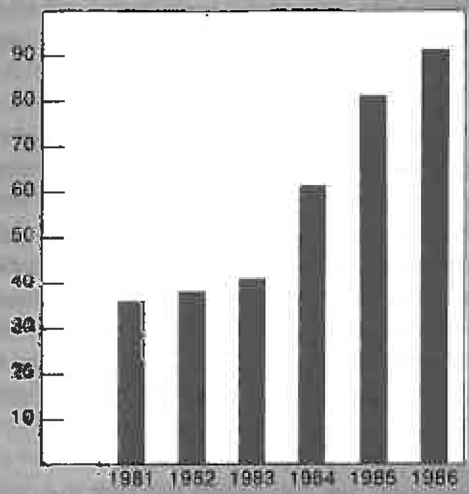
Source: Central Bureau of Statistics

What was not normal, however, was the strong demand stimulus confronting Mainland Norway as a result of the development on the continental shelf (chart 2). Investments rose by more than 75 per cent over the four years from 1982 to 1986, reaching a level which was more than 50 per cent higher than in the entire manufacturing industry. Investments in petroleum activities were primarily financed from abroad, thus entailing no notable tightening on the credit market with an effect on other demand.

Taking these exogenous components of demand as given, fiscal and credit policy should be geared to adjusting domestic demand in a way which is compatible with constraints imposed by the supply of labour and productive capital and a sustainable balance in the external economy. This would have implied a tightening of demand. In fact, however, the opposite took place.

Fiscal policy was more on less neutral over the years 1981–1983. Given the widespread impression of increasing unemployment and plentiful foreign exchange reserves, it was no longer possible to keep the lid tightly fastened. It is especially noticeable that the most expansionary year was 1985 when the upturn was otherwise moving at full steam.

Chart 3
Registered domestic credit supply to the private sector and municipalities. Billion kroner



Demand stimuli from abroad and from the petroleum activity, together with an expansionary fiscal policy, laid the basis for pressure in the Norwegian economy. A steep increase in employment and a tight labour market created conditions for high income growth and great optimism for the future. The result was a strong credit demand which readily materialized in a credit market in which the ability of credit to find new channels grew steadily.

Source: Central Bureau of Statistics and Norges Bank

The growth in employment of some 7 per cent through the years 1983–1986 and a tight labour market created a basis for high income growth and considerable optimism about the future. This resulted in a strong demand for credit at a time when quantitative regulations were in the process of losing their effect (chart 3). The consequences of this were drawn through deregulation, but without the introduction of effective instruments which could bear on real costs of borrowing. On the contrary, the nominal interest rate level had been slightly reduced and the deductibility of interest payments for tax purposes had been extended to typical consumer credit. In this situation rising investments and an expansionary fiscal policy necessarily resulted in a considerable credit expansion.

The conditions I have mentioned here had produced a need for a substantial tightening of Norway's economic policy. But as long as petroleum revenue was high and foreign exchange reserves rising, such adjustments could be postponed. The fall in oil prices made it even more imperative than before to revise policy, and in the course of 1986 a great deal was actually done.

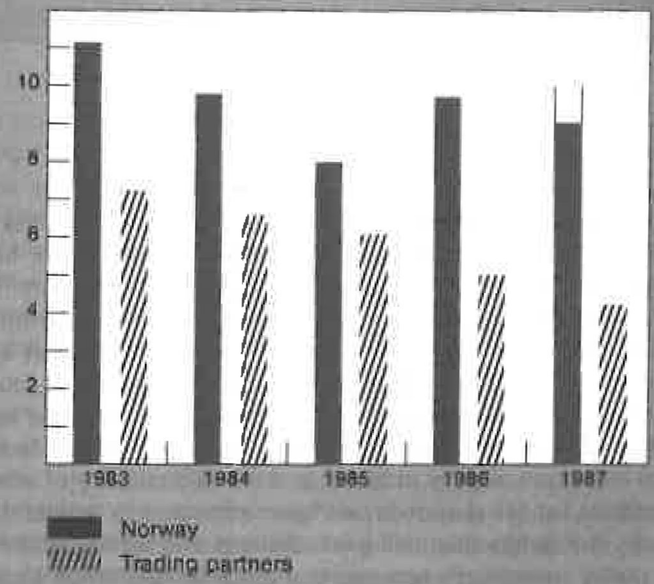
Fiscal policy adjustments

The adaption was primarily carried out by tightening an initially expansionary fiscal policy for 1986 during the year. The tightening, however, appears to have gone no further than eliminating the budget's expansionary nature. What was politically feasible took precedence over what was economically necessary.

It obviously takes time for a ship moving at full speed to change direction. The expansionary policy of earlier years generated a growth impetus which has continued to have effect. Pressures in the labour market resulted in a strong rise in income and thereby a continued growth in consumption. Housing investments grew by 10 per cent. Sheltered industries, which without difficulties could pass on their costs, increased their fixed investments by nearly 15 per cent in 1986. Domestic demand thereby increased as much as in the previous year, in spite of fiscal tightening and warnings of difficult times to come.

Against this backround, we can hardly say that the new realities have marked our everyday life in the year that passed. In a number of areas the development in 1987 will also be determined by decisions we made during the upturn: the requirements as to subsequent adjustments will be correspondingly greater.

Chart 4
Growth in hourly wage costs in manufacturing industry. Per cent



The tendency for wage costs to grow more strongly in Norway than among her trading partners was reinforced both in 1986 and 1987. Because of the reduction in working hours and the wage carry-over, hourly wage costs in Norwegian manufacturing industry show a 9 per cent increase before the centralized and local wage negotiations even start. Among Norway's trading partners, hourly wage costs are expected to rise by a little over 4 per cent between 1986 and 1987.

Source: OECD, IMF and Norges Bank

The reduction in working hours will, in isolation, result in an increase of close to 5 per cent in manufacturing industry's wage expenses from 1986 to 1987. This alone is more than the expected total increase in wages for our main trading partners (chart 4). In addition, the carry-over from 1986 to 1987 for manufacturing industry is about 4 per cent. Even before the centralized and local pay negotiations begin in 1987, Norwegian manufacturing industry will thus have recorded an increase in costs of 9 per cent. The situation in other sectors is not much better. The labour market was very tight at the beginning of 1987, and the reduction in working hours will contribute to further amplifying the pressures. The shift of resoures to exposed activities, which the fall in oil prices necessitates, will thus be delayed.

In this situation fiscal policy cannot really be too tight, and there could be said to be good reasons for taking the tightening further than has been done in the government budget for 1987. It is particularly important to cut expenditure which otherwise would have an inherent tendency to rise in the years ahead.

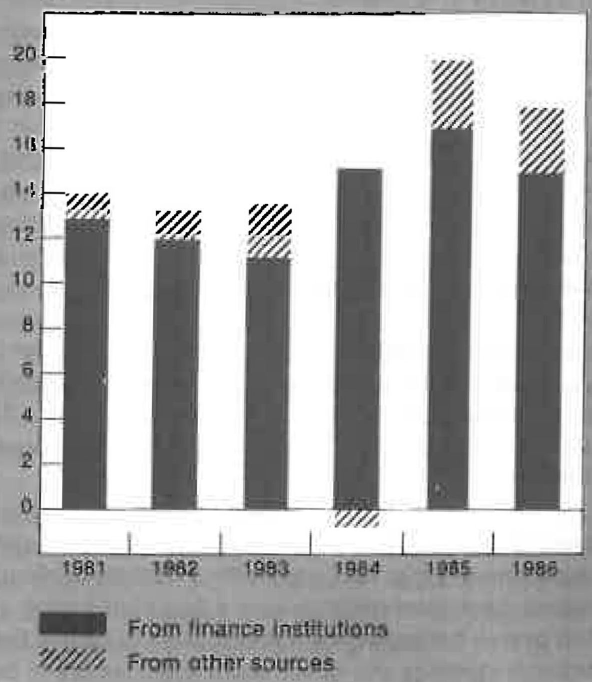
Nonetheless, an activity-adjusted tightening of 1.6 per cent is by no means negligible, and even with a decline of about 30 billion kroner in petroleum revenue over a two-year period, the budget is still in overall balance before loans to state banks. Even without petroleum earnings our government finances are in better shape than in most other countries. This is a strength to be maintained.

A credit policy that failed

In credit policy, on other hand, there is little to lose. Through the three years 1984–1986 the registered credit supply amounted to about 235 billion kroner (chart 5). Deflated to real values, this corresponds to an average annual increase of 10 per cent. These registered figures are, on average for the years 1983—1986, more than 50 per cent higher than projected in the National Budgets. Additionally, the *actual* credit supply (after adjustment for distortions caused by credit regulation) was considerably higher. The discrepancies, both between planned and registered figures and between these and the actual credit supply, were of such a magnitude that they necessarily had a strong impact in the real economy.

The emergence of parallel markets and a more developed credit channelling system outside the banking sector have probably increased the efficiency of the credit system to some extent. At the same time, however, more of the credit goes through channels where the authorities have less insight and wield little influence. There may also be grounds for concern that, should solvency be threatened, there is not the same buffer of reserves and funds with which to deal with the problem in the case of credit channelled outside the credit system.

Chart 5
Growth in domestic lending to the private sector and municipalities



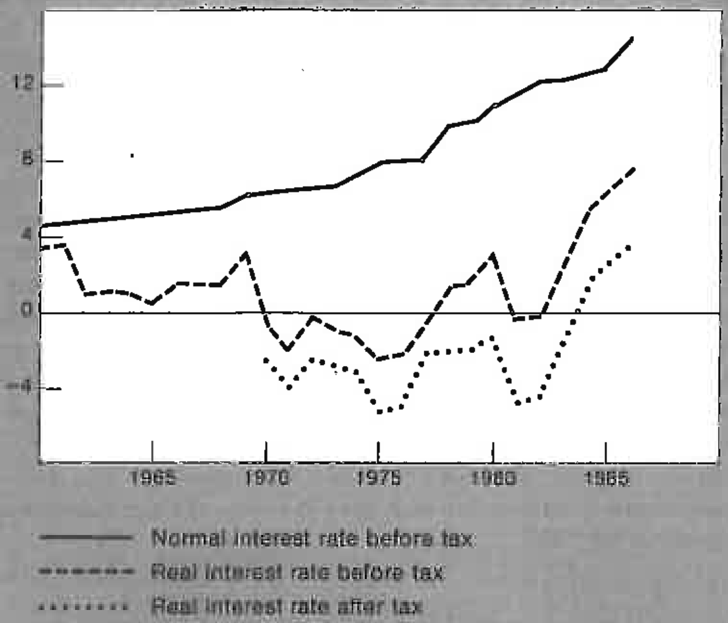
The growth in domestic lending increased in 1984, and accelerated sharply in 1985. Although the rate of increase declined somewhat during 1986, it was nonetheless still very high. The volume of loans from sources other than finance institutions has shown a substantial increase in the 1980s.

Source: Central Bureau of Statistics and Norges Bank

Credit regulations have given rise to considerable ingenuity in circumventing them. When the regulations were phased out, the ordinary credit institutions showed just as much inventiveness in restoring and gaining market shares. A marketing of loans and an array of borrowing opportunities arose which we had never seen the likes of before – in a situation with a very high demand for credit. The reduction in inflation from 1981 to 1985 raised the borrowers' real interest rates in this period (chart 6). A slight decline in marginal tax rates increased the real after-tax interest rate even more. However, this increase started from a very low – indeed negative – level. Given the external factors which stimulated the demand for credit in 1984–1985, as well as the development in the way the market functioned, real interest costs were obviously far from being high enough to contain the expansion in credit.

It may rather appear that borrowers faced a credit market where the burden of indebtedness was reduced in spite of higher real after-tax interest rates. In the parallel markets, instalment-free market

Chart 6
Interest rate development



The real after-tax lending rate (for a typical manufacturing worker), which in the 1970s was markedly negative, has risen substantially in the 1980s. However, real interest costs have not nearly been high enough to keep the expansion in credit in check. The current high real interest rate level together with weaker economic prospects must be expected to have clear effects on credit demand in the period ahead.

Source: Norges Bank

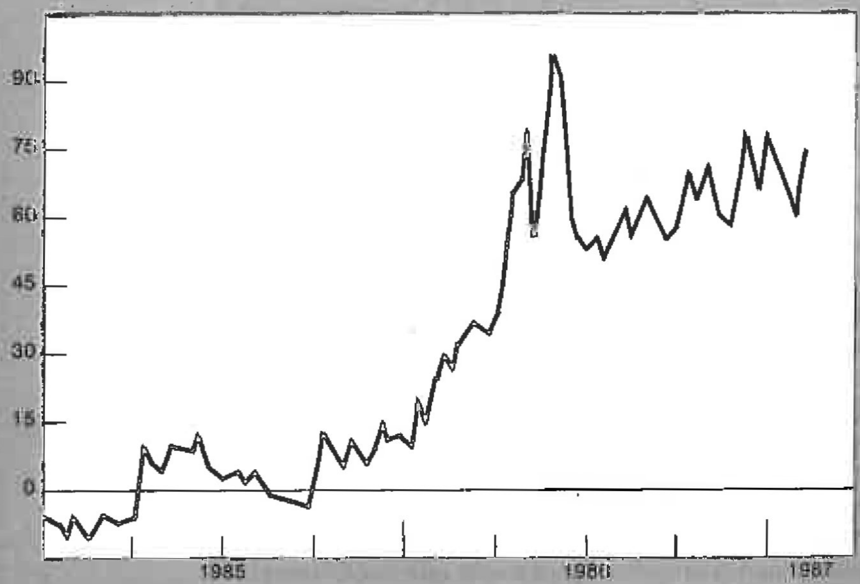
loans were granted. This contributed to reducing the burden of debt servicing in the short term. The banks also followed up by shifting towards loans with a longer repayment period, particularly for housing purposes. The use of annuity loans and possibilities for refinancing have increased. Instalment payments, which are a type of saving, have been postponed and their real value reduced.

The increased volume of market loans and easier terms for loan repayments from the finance institutions may in itself have contributed to a higher demand for credit in recent years, particularly if the borrowers had a relatively short-term perspective on the burden of debt servicing. To some extent, therefore, the supply in the credit market may be said to have created its own demand.

Throughout 1984 and most of 1985 the interest rate level was subject to political constraints through interest rate declarations, and Norges Bank's interest rate on loans to the banks had to be adapted to this. When the system of interest rate declarations was replaced by interest rate monitoring in the autumn of 1985, this did not really represent a break with earlier interest rate managament. In spite of a sizeable capital outflow Norges Bank's interest rate was maintained at 13 per cent until it was raised to 14 per cent during the currency unrest last spring. With the exception of just a few days it was thereafter kept at this level until early December. At the same time, the rise in prices increased — and most likely also price expectations — later in 1986, so that the effect on the real interest rate was reduced, and the expansion in credit and liquidity continued throughout the year.

This gave the private sector an opportunity to cover its financial deficit by raising loans in the Norwegian market. In order to maintain a specific interest rate level, which for most of the year was politically determined, Norges Bank had to supply kroner to the banks (chart 7). These kroner were used to buy foreign currency in the market, and Norges Bank supplied the market with foreign currency worth some 45 billion kroner in order to maintain the established krone exchange rate. Interest rate policy thus entailed that more than the entire current account deficit was covered by Norges Bank. It was our sizeable foreign exchange reserves which made this interest rate policy possible. The break with this approach came in connection with the Government's economic policy programme for 1987.

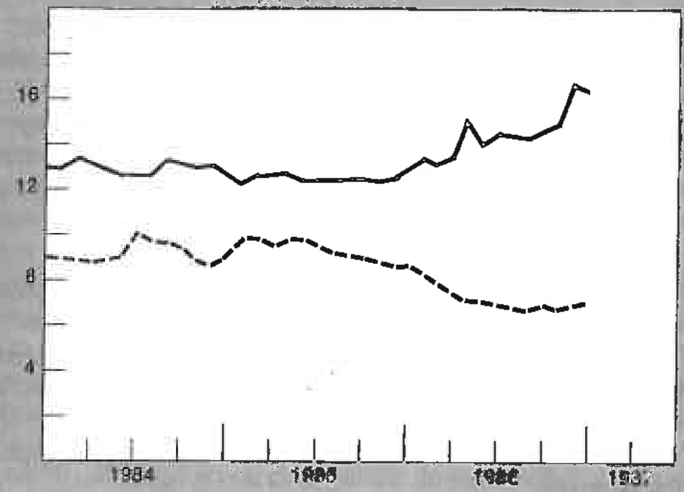
Chart 7
Net liquidity supply from Norges Bank
Billion kroner



In order to prevent interest rates from rising beyond the stipulated level, Norges Bank was in 1986 compelled to lend kroner to the Norwegian market on a very large scale. The funds were used to finance the private sector's purchases of foreign exchange which were to cover the import surplus and interest deficit vis-à-vis abroad. Norges Bank supplied the foreign exchange by drawing on its foreign exchange holdings.

Source: Norges Bank

Chart 8. Three-month interest rate



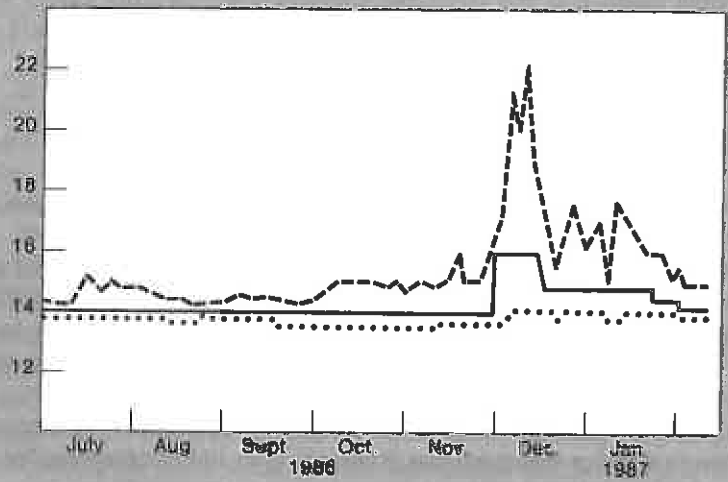
——— Norwegian kroner

- - - - - Basket interest rate

The need for foreign exchange cannot be met in the long term by drawing on the foreign exchange holdings. In order to bring about the necessary capital inflow, the domestic interest rate must be high enough to persuade the private sector to borrow abroad. If the interest rate differentials vis-à-vis abroad are to be reduced once again it is crucial that the Norwegian authorities implement an economic policy which both is, and is perceived to be, credible.

Source: OECD and Norges Bank

Chart 9. Interest rates in the money and capital market



——— Norges Bank's lending rate

- - - - - Eurokrone interest rate, one-month

· · · · · · · Government bond interest rate, five-year

Imbalance in the exchange market was the background for the increase from 14 to 16 per cent in Norges Bank's lending rate on 2 December last year. A tight liquidity policy, together with uncertainty in the market about the development of the krone exchange rate, caused interest rates in general in the money market to rise more than the Central Bank's lending rate. The interest rate increase spread rapidly to other parts of the credit market, to the banks and to the bond market. The situation in the exchange market improved in the latter part of January, enabling Norges Bank to lower its lending rate. Other interest rates have duly been lowered.

Source: Norges Bank

From interest rate management to exchange management

In accordance with recommendations from Norges Bank it was established that the interest rate level had to be geared to consideration for the krone exchange rate and foreign exchange reserves. The deficit on the current account of the balance of payments was to be primarily covered by capital imports to the private sector. A continued outflow, like that in 1986, would eventually threaten our foreign exchange liquidity.

We are confronted here with a relationship between three variables — the interest rate, the exchange rate and foreign exchange reserves — which cannot be stipulated simultaneously. One of them must yield. In 1986 we allowed the exchange rate to yield when we devalued. Thereafter Norges Bank continued to keep the interest rate at a level where the burden had to be carried by our foreign exchange reserves.

Now that we have decided to let exchange considerations be determinative for the interest rate, it means that of the three variables it is the interest rate which must yield. It must be sufficiently high compared with interest rates abroad for the private sector to find it profitable to raise loans abroad to cover its foreign exchange requirement (chart 8). This interest rate differential must be greater the less confidence market participants have in our policy. If the interest rate level is to be reduced, it is therefore essential that the policy be considered as credible with a view to achieving a sustainable balance in our economy. Credibility will be significantly enhanced if this policy receives broad support, in political quarters as well as from the business sector and labour and management organisations. Conversely, conflicts and a lack of stability will reduce confidence and require a higher level of interest rates.

The first test of this new policy came in December when Norges Bank raised its lending rate by 2 percentage points and initially succeeded in halting the foreign exchange outflow (chart 9). When the unrest had subsided, we again lowered the interest rate slightly and have subsequently proceeded further. There now appears to be a growing understanding of the fact that the interest rate is not a variable that can be politically determined. It has to be determined on the basis of market conditions. The more general acceptance this policy receives, the greater will be the possibilities for lowering the interest rate.

The fact that the new approach entails that the interest rate in the money market is now determined by decisions made by Norges Bank seems to have given some the impression that a new power centre has been established in politics. It is probably more correct to say that we are facing a broadening of the responsibilities — as an executive body in monetary and credit policy — that legislation has vested in Norges Bank. But these duties will of course invariably be discharged in accordance with the guidelines for economic policy that are drawn up by our political authorities.

Credit managament and the interest rate

At the moment it is thus exchange rate stability and foreign exchange reserves which represent the market conditions on the basis of which the interest rate level must be determined. The situation has compelled us to abandon interest rate management in favour of exchange management. However, our exchange rate level is stipulated with a margin of altogether 4 1/2 per cent around the central value. The system presupposes that we accept fluctuations within this interval based on an assessment of how currency stability can best be safeguarded in the longer run. Exchange management sets certain limits for the interest rate level without our knowing in advance what these limits are. We are therefore prevented from establishing a specific interest rate level which can be interpreted as "right". The need for exchange management also limits our possibilities for using the interest rate to influence the demand for credit, although some possibilities do exist within the existing swing margins. As our balance of payments and thereby our exchange position is gradually strengthened, our scope for manoeuvre with regard to determining the interest rate level will increase. It is nevertheless difficult to see any good reason why we should revert to interest rate management.

In a credit market of the type which may realistically be expected we will not be able to control prices and volume simultaneously. Rationing of credit has become a steadily less effective instrument, and its influence – as far as it goes – is negative for the community and results in poor utilization of capital. People with good bank connections and the best collateral are the ones who stand to gain. To the extent exchange considerations give us scope for manoeuvre in stipulating the interest rate level, the choice will rest between interest rate management and controlling the volume of credit, or – put differently – between interest rate policy and credit policy. Up until December last year we chose to pursue an interest rate policy.

The attempts to contain the supply of credit, however, have in practice entailed that interest rate policy has been conducted through regulations which increase the banks' lending rate. This is a cumbersome and complicated approach compared with measures which have a general effect on the interest rate in the money market. More serious is the fact that the activity on the credit market is channelled outside the finance institutions' balance sheets. This is a tendency we probably would have faced in any event, and one which concerns the authorities in other countries as well. But our traditional use of instruments serves to aggravate the problem.

The interest rate has an effect on credit demand to the extent that it influences the real borrowing costs to be borne by the borrower himself. This means, first, that an increase in the interest rate level must inevitably be followed by an increase in lending rates by the finance institutions. But there is a need to develop a broader market for loans than at present, offering alternatives with respect to the period during which the interest rate is fixed. The immediate link between the interest rate charged by Norges Bank on its loans to the banks and the banks' interest rates on housing loans which we have recently observed is neither a necessary nor desirable element in a free credit market.

Secondly, it means that the more inflation is expected to pay for the loan, the higher the interest rate must be; and the more the borrower can obtain relief by deducting interest expenses for tax purpose, the higher the interest rate must be. The combination of inflation and deductibility of interest expenses results in an even higher interest rate. The same line of reasoning can be applied to interest receipts on assets.

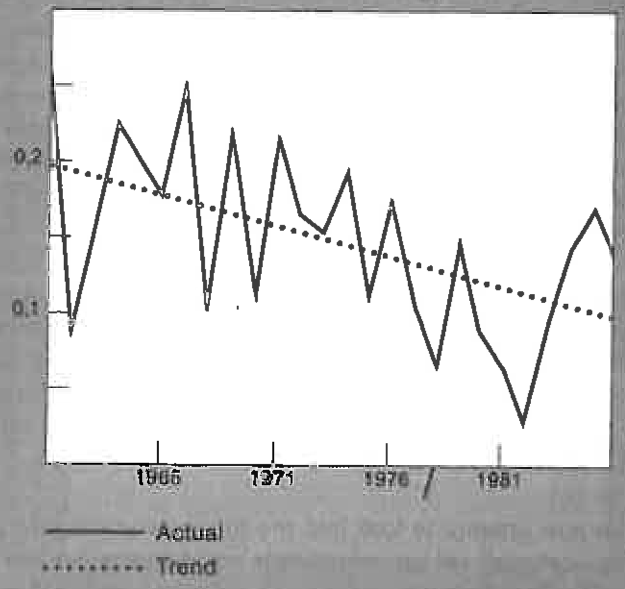
Consideration for stability in the foreign exchange market implies we must expect a fairly high interest interest rate level in the immediate future. A fiscal policy which both strengthens confidence in the value of the krone and reduces the demand for credit should gradually pave the way for a decline in interest rates. The same applies to falling inflation and a reduced tax subsidisation of interest expenses which, through their effect on the demand for credit, will also reduce the pressure in the exchange market.

There seems to be a general consensus about reducing the interest rate level through lower inflation. But if the interest rate is to maintain its function, it is just as important to reduce the distortions resulting from the tax treatment of both borrowing costs and return on capital. International organisations which study the Norwegian economy have repeatedly emhasized the need to do something about this. Some progress has been made in the tax resolution for this year, and it would be desirable to proceed rapidly in this area. Of course, concessions must inevitably be made both to tradition and to what is politically feasible. Such concessions, however, can be expensive in the form of uneconomic resource use.

Effects of cheap capital

Throughout the postwar period it has been assumed that capital should be cheap and that accumulation of real capital should be stimulated, both through tax provisions and through the credit supply. After having been stable for a long period, from 1960 to the mid–1970s the real interest rate moved on a clear downward trend. This was due to a rising rate of inflation – with which the nominal interest rate did not quite keep pace. Since the demand for credit stayed high, the rationing of loans had to be expanded and implemented more stringently. Under such conditions it is, as I noted earlier, the safest rather than the most profitable investments which receive priority. We would therefore expect investments to provide a declining return in terms of economic growth. If we look at the relationship between the growth rate and the investment rate in the economy as a rough indication of the return on investments,

Chart 10
The ratio of GDP growth to gross investments as a share of GDP. Mainland Norway



The ratio between real GDP growth and gross investments as a share of GDP (the investment quota) in the previous year gives a rough indication of the yield on investments. Over the past 25 years this ratio has been on a downward trend. Thus our investments may be said to be yielding steadily lower returns.

Source: Central Bureau of Statistics and Norges Bank

this is exactly what we find (chart 10). The ratio shows a clearly declining trend over the last 20 years.

The tendency of a declining real interest rate is magnified if we look at the after-tax real interest rate. This is perhaps of greater importance for the household sector than for industry and trade. But, for whatever importance it may have, it tends to make loan capital even cheaper.

This is not the place to attempt to provide an exhaustive explanation for the conditions referred to here. Among other things, a tax system whose entire structure was based on nominal amounts, i.e. which assumes low inflation to have a reasonably neutral effect, had to result in further distortions with regard to the choice of investment objects. Nor can we disregard the possibility that investments have to some extent been used to compensate for a fall-off in labour productivity.

The question of the reasons behind the declining return on capital, and thus what we can do to reverse the trend, is as important as it is difficult. We in Norges Bank therefore hope be able to continue our efforts to shed more light on the problem.

Limits to debt

In my address last year I showed that a continuation of the economic policy from the first half of this decade and into the 1990s was not a viable approach. The projections were based, among other things, on no change in the formulation of economic policy compared with the first half of the 1980s, i.e. a tighter policy than in 1985–1986. The calculations illustrated an imbalance in the economy which would result in an unmanageable foreign debt later in the 1990s. At the same time, the labour market would show a weaker trend.

When Norway has a current account deficit, this must necessarily show up as a financial deficit for some Norwegian sectors. For 1986 and 1987 we do not find it with the central government, and in the case of last year not with the municipalities either. The oil companies account for part, but most of the deficits refer to other enterprises and the household sector.

If we now attempt to look into the future, who will then account for these deficits? Let us concentrate on Mainland Norway, since we assume that both the petroleum sector and shipping will handle their own financing problems.

In Norges Bank we have attempted to analyze this question on the basis of the assumptions used as a basis for the projections in the National Budget. The intention has been to shed light on the problem rather than to present any type of forecast.

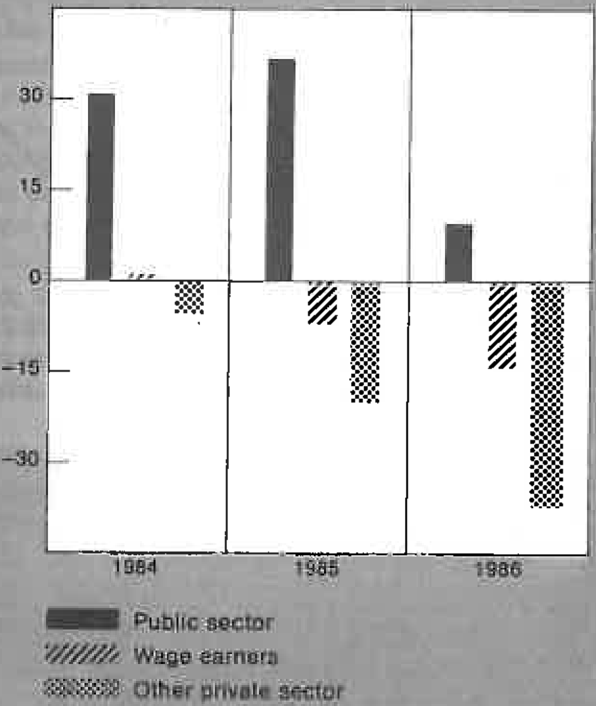
The deterioration in Mainland Norway's position began as early as 1985 (chart 11). The fact that the current account surplus remained so high that year is in particular attributable to the sharp increase in the financial saving of the petroleum sector. However, both other enterprises and the household sector recorded a steep decline in financial saving. This tendency was amplified in 1986, and at the moment seems to be continuing into 1987.

The projections made entail that the private sector may continue to show negative financial saving, i.e. be a net borrower, throughout the entire period. The question is to what extent such a development will materialize, and what factors will correct it.

During the past few years the household sector has increased its debt burden and its net interest expenses rather dramatically (chart 12). With a higher interest rate level and a probable decline in real income in 1987, this development will be magnified. We may assume that before long the result will be a slower rise in debt and positive net financial saving.

It is also unlikely that private enterprises will want to increase their net debt at the current rate and, even it they did want to, the question is how long their creditworthiness would enable them to do so.

Chart 11
Financial saving for Mainland Norway
Billion kroner



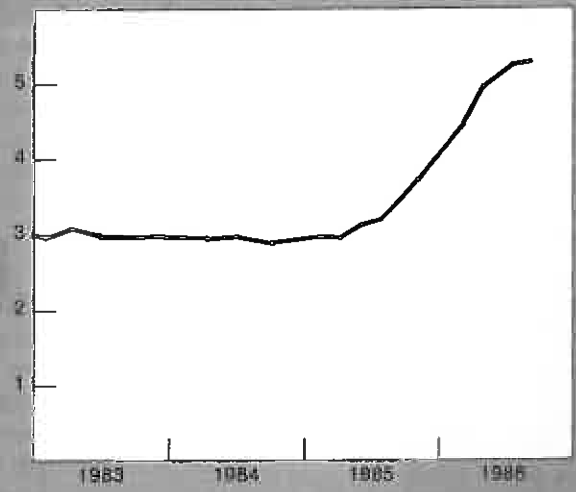
Even though the public sector increased its financial saving in 1985 thanks to voluminous petroleum earnings, Mainland Norway's financial saving started to decline in the same year. A sharp fall was recorded in financial saving both by enterprises and wage earners. The fall continued in 1986. This, together with the declining price of oil, took the country as a whole from a positive financial saving (current account surplus) of 25 billion kroner in 1985 to a negative financial saving of 33 billion kroner in 1986.

Source: Norges Bank.

But if the private sector will not increase its debt, it must reduce its demand. This will have consequences for the level of activity and employment. Sustaining employment will require that the central government accepts the necessary burden through budget deficits. This deficit would in the event have to be financed by borrowing abroad, since domestic borrowing would presuppose positive private financial saving and a correspondingly stronger reduction in private demand.

The Norwegian state presently enjoys first-rate creditworthiness. If it is to continue to do so, foreign capital markets must have confidence in our ability to carry out the adjustments in our economy which a sustainable balance will require. Large-scale borrowing to maintain a high level of employment is hardly commensurate with what other countries would consider to be a sustainable balance. Our creditworthiness does give us some room for manoeuvre, but scope for manoeuvre which is used will also be used *up.*

Chart 12
Households' net interest expenditure as a percentage of disposable income



The household sector's net interest expenditure (seasonally adjusted and adjusted against the National Accounts) as a share of disposable income increased in 1985 and 1986 from 3 per cent to over 5 per cent. The reason is partly the decline in households' net financial assets and partly that lending rates have risen faster than deposit rates.

Source: Central Bureau of Statistics and Norges Bank

On the other hand, there is little to be gained from scope for manoeuvre which is not utilized. Limited external borrowing as part of a planned and relativity rapid adjustment may perhaps therefore be acceptable. But borrowing which only postpones the problems will make adjustment even more difficult when it eventually becomes unavoidable.

Most of the OECD countries which have had current account deficits have depended on non-government capital imports: the government has borrowed on the domestic market to cover its financing requirements. The few countries that have pursued a policy based on government borrowing abroad have now abandoned that approach. This is true of, among others, our Scandinavian neighbours.

If no Norwegian sectors will or can accept the financial deficits, part of the balance of payments problems which are foreseen will surface as an employment problem. This does not mean that our concern about the balance of payments has been exaggerated. On the contrary, it means that the deficits are so unwieldy that it will be employment that is affected instead. We could enter the 1990s with *both* a balance of payments *and* an employment problem. This is precisely the situation we at Norges Bank have in mind when we emphasize that a basic goal of policy must be to safeguard a sustainable balance in the external economy.

Return to realities

The prospects outlined here do not perhaps seem very encouraging. But properly speaking the reality facing us is not basically different from the one familiar to us ten or fifteen years ago when we were living reasonably well on what our own capital and labour could provide, without the support of micro-organisms from prehistoric times. Nor is the outlook more alarming than the situation many other countries have been and still are facing. If the situation seems bleak to us, it is perhaps because we are blinded by the good fortune which has repeatedly come our way.

We are, indeed, still fortunate in many ways compared with many others. In the first place, we have the unfavourable experiences of other countries to learn from — in addition to the mistakes we ourselves have made previously.

Secondly, we start the restructuring process with a government budget which still shows a surplus and no net interest expenses to burden government finances. Other countries have mostly started the restructuring process after the government has fallen deeply into debt.

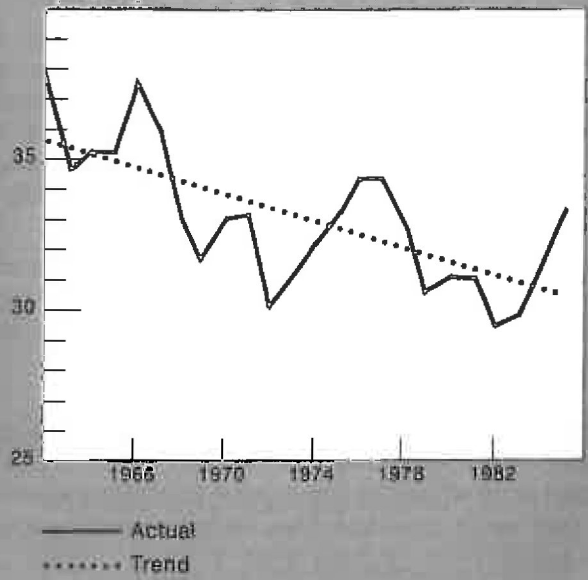
Thirdly, we are still a net exporter of petroleum and will continue to be so. The wealth is there, even though the income flowing from it is not as great as we once thought it would be.

The task confronting us is partly to contain our domestic demand to our actual income, and partly to make good the shortfall in petroleum export earnings with income from other production. Achieving a better accord between income and its use entails a policy which is often referred to as the "austerity approach". This policy is necessary, for reasons I have already expounded. Applied on its own, however, it would necessarily lead to unemployment. To counteract this, the market-oriented areas of our economy must pursue a policy of growth. What are the preconditions for this?

We should first acknowledge that we do not have a particularly strong position to start from. Manufacturing sectors exposed to competition have only recently regained their 1974 level. Nor is there much idle capacity available to them. Much of our merchant fleet is registered under foreign flags, and in the years ahead it will provide less income and employment for Norwegians than it has in the past. Of course, we also have encouraging growth fields, but we have no broad basis from which to expand in market-oriented activities. Thus, it is all the more important that conditions favourable to the establishment of new activities are created.

One of the conditions for this is that a reasonably high proportion of society's capital saving is used in such a way that it serves market-oriented production, on the basis of market criteria. A properly functioning competitive credit and capital market has an important task here. But a precondition for an economically efficient market

Chart 13
Proportion of gross investments in Mainland Norway in which investment decisions are made under general market-oriented conditions



The chart shows total gross investments in Mainland Norway less investments in public services and publicly owned enterprises and also investments carried out under especially favourable conditions in the primary industries and in the housing sector. The fact that a steadily increasing proportion of investments is being determined outside the market is in all probability a factor contributing to the low yield on investments.

Source: Central Bureau of Statistics and Norges Bank

is that serious distortions in the channelling of capital flows are not created by the tax system. Our tax system hardly satisfies this requirement.

We have also allowed a growing share of investments to be determined outside the market, such as investments in the public services, housing and primary industries and in various types of public enterprise. Such investments are not necessarily poor, but we cannot expect them to provide a high return if the main emphasis in the decision is placed on, for example, regional development, environment, or distribution considerations. What these provide can in many respects be equated with consumption, and if we attach major importance to such considerations we must accept that a great deal of resources will go to investments and correspondingly less to consumption.

The lion's share of the investments made are the result of decisions made by government bodies or are influenced by special conditions established by public bodies. Through the past 25 years a declining share — and in recent years only about 30 per cent — has been determined on the basis of market-oriented conditions (chart 13). It is not unreasonable to assume that this has contributed to the decline in the ratio between the growth rate and the investment rate which was pointed to earlier.

It is imperative that the new activities that are created under general, market-oriented conditions are able to absorb the labour which becomes available when demand tapers off. Our current high employment level makes this task at once easier and more difficult. It will be easier in the sense that we already have a labour force with job experience. We see in other countries the difficulties involved in employing those who have been out of work for a long time. This is particularly true of young people without any well established ties with the labour market. Unemployment goes up more readily than down.

But the task will be more difficult to the extent that the current pressure in the labour market has resulted in a high wage level and strong pay demands. Our high cost level and the increase in costs which will take place in the current year pose a threat both to the jobs we have and to those to be created.

In 1987 the main problem in the labour market will continue to be that it remains too tight. Just as the expansionary policy in 1984 and 1985 only had its full impact two years later, the tightening of policy which must now be implemented can not be expected to have a real effect until next year. Moreover, in the labour market the effect will be delayed as a result of the reduction in working hours.

The situation in the labour market may gradually come to resemble that which developed in the period 1982–1984. On that occasion it was counteracted by increased petroleum activities and an expansionary policy financed by oil revenues. Now petroleum activities will be on the wane, and sizeable oil revenues are not to be expected. Our previous experience tells us more about how this situation should not be tackled than about what in fact should be done.

In the 1970s we were able to finance expenditure from external government borrowing. This was easy enough because both we and the international capital markets expected an imminent and strong rise in government revenues. Today, there is little basis for such an expectation. The government will therefore not be able to resolve an employment problem through an expansionary fiscal policy. On the contrary, a declining level of activity will weaken the government's financial position. If the present position is to be maintained, there will be a need for continued tightening. While an expanding level of activity helped to boost the budget surplus in 1985, in spite of an expansionary policy, we will register the opposite effect in the years ahead.

We will not be able to stimulate activity by means of liquidity creation and a lower interest rate level. That would reduce the business sector's interest in borrowing abroad and increase the burden on the foreign exchange reserves. A rise in costs which increases the uncertainly about the value of the krone will exert additional upward pressures on the interest rate level.

The situation can in fact only be handled constructively by allowing the burden to fall on our real income. And it must be effected through nominal incomes if the value of the krone is to be safeguarded. In the light of this, and given the built-in pay increases which the carry-over and reduction in working hours already entail, a "zero increase" settlement this spring, although positive by itself, is actually too high.

In a longer perspective, however, we must not solely concentrate on the *level* of wages. It is equally important to restore flexibility in income formation so that new jobs can be created. For some time now incomes for various groups have been linked together by political decisions, tradition and agreements. A form of solidarity has prevailed in a period when the government was in a position to guarantee employment. When the government can no longer do this, solidarity between those who have a job will exclude those who do not. In other countries we see how the most dangerous form of class distinctions develops between those who are employed and those who are not. It is above all those who are in danger of falling into this latter category who need our solidarity.

When demands are made for lower labour costs, it is often pointed out that other cost elements are also important, especially capital costs. I have already tried to show that attempting to keep capital costs low will hardly result in a sound utilization of capital. However, low capital costs also make it profitable to replace labour with capital. Measures to reduce capital costs in relation to a level compatible with equilibrium in the capital market will therefore weaken employment. Moreover, such measures will entail some type of subsidy which ultimately must be borne by the wage-earners themselves.

It is often said that Norway must accept being a high-cost country. It is actually difficult to see any real meaning in such a statement. A country can only allow itself a cost level which is justified by the value of its production. The exigencies of a sustainable balance will in the long run also determine what cost level can be maintained. If it has risen too high for a balance to be established, we can reduce it through planned measures involving a limited welfare loss. The alternative is to have it fall as the result of a forced tightening of policy, unemployment and devaluations — with a far greater loss of welfare. Living with a cost level which is not in accord with a sustainable balance is a non-existent alternative.

Strong words have been used to characterize our country's difficult economic situation, and I have perhaps added fuel to the fire. Yet we must not forget that, compared to others, we still have important privileges intact. Many countries face far greater problems and are less well placed to solve them. If we feel that the realities now confronting us are akin to a crisis, it is perhaps because we have for so long eluded normal economic difficulties. Whenever economic laws were to apply to us, circumstances exempted us from them. No country, however, can base its future on permanent exemptions from economic legalities.