The economic outlook

Speech by Governor Øystein Olsen to invited foreign embassy representatives, Norges Bank, Oslo.

The speech is based on the annual address 2012, the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 14 March, Monetary Policy Report 1/12 and previous speeches. Please note that the text below may differ slightly from the actual presentation.

Demanding time for Europe

Excellencies, Ladies and Gentlemen,

In the course of the past two years we have seen economic problems spread across debt-laden countries in Europe. Greece was the first country to experience a financial collapse. The Greek government had to resort to external financial assistance in spring 2010, followed by Ireland and Portugal. The turbulence spread further in autumn last year.

Several euro area countries are now struggling with soaring public debt and weak competitiveness in addition to restructuring and public budget cuts. Confidence in some countries' ability to service debt has been weakened.

Chart 1 Global trade imbalances

The root causes of the crisis were global trade imbalances, with high saving in emerging economies and comparably large deficits in many advanced countries. The imbalances drove down long-term interest rates to very low levels and the appetite for risk grew. Inadequate financial sector regulation led to a further deepening of the imbalances.

Chart 2 Capital market failure

Four years after the financial crisis engulfed the world, a European version has now emerged. Both market participants and the authorities failed in their assessments after the introduction of a single currency. Prior to the introduction of the Economic and Monetary Union, there were wide differences between interest rates facing different European countries, which primarily reflected different inflation expectations across countries. But through the 1990s, long-term interest rates drifted down to German levels. Over the next 10 years, sovereign interest rates were fairly similar – and very low – for all euro area countries despite wide differences in debt levels, budget deficits and growth rates. Market participants did not take into account differences in sovereign creditworthiness. Sovereign debt was treated as virtually risk-free, both in the markets and by the authorities. The period contrasts with the recent two to three years during which interest rates on sovereign debt have widened sharply. For many countries, interest rates have reached very high levels. In

retrospect, we see that market participants failed in their risk assessment through the ten years following the introduction of the euro.

Economic policy also failed. EU rules relating to budget deficits and public debt were disregarded early on when Germany and France exceeded the limits they had so eagerly advocated when the European Monetary Union was established. Other countries followed their example. Low interest rates made it easy to finance deficits by issuing new debt.

When financial markets collapsed in autumn 2008, the authorities had to intervene. Bail-out packages for banks shifted debt from private to public hands. Governments increased spending to curb the fall in activity.

But Keynesian policy – increased spending in order to stimulate demand during a downturn – requires a willingness to exercise fiscal restraint during an upturn. Many countries already had large budget deficits and high debt before the crisis, despite many years of prosperity. Limited growth capacity in the private sector also came into evidence when some countries could no longer stay afloat on borrowed funds. Good times turned into bad, with the need for crisis-related measures. The burden became heavy to bear.

Many countries are now struggling to rein in large deficits and rising government debt. Structural reforms are being implemented in Europe. Pension rules are being tightened and tax systems are under review. The cost of such reforms would have been lower in good times.

Chart 3 Current account for selected countries

A lack of fiscal discipline is not the only factor behind the relatively high interest burdens facing Greece, Portugal, Spain and Italy. Public deficits rose in tandem with a fall in private saving. Countries lived beyond their means and accumulated current account deficits and substantial debt while their debt-servicing capacity weakened. The result is a deterioration in their creditworthiness.

Chart 4 Current account and fertility rate

The combination of large deficits and growing demographic problems is particularly challenging, as is the case for southern European countries, where fertility rates are well below the replacement rate and lower than the average for advanced countries.

The demographic challenge will be even greater ahead. In some of the countries the number of pensioners will be close to the number of economically active. The basis for economic growth is thus weakened. The burden of rising debt and pension payments will be heavier.

It takes a long time to reverse demographic trends. Financial incentives can be effective. Norway, with favourable support schemes for families with children, has a relatively high birth rate. In other European countries, there is a risk that these hard times will exacerbate the demographic challenge. Unemployment, in particular among youth, has risen sharply and many people have a dark view of the future.

The events of recent years have brought fresh experience and reminded us of several historical lessons.

Economic policy must be sustainable. Governments must save during upturns in order to weather downturns. At the same time, there are limits to what economic policy can accomplish if the economic foundations are being eroded. A competitive business sector is crucial to maintaining growth and welfare. This also applies to Norway.

The financial crisis was a reminder of how risk can be misassessed. Moreover, risks that operators seem to be managing well individually may prove to be a considerable strain on the financial system as a whole. As a response to this, a new macroprudential surveillance framework is now in the making.

Norway, which is in a surplus and net asset position, faces some particular challenges. As investor and manager of the Government Pension Fund Global, we have seen that prices and yields can react strongly to uncertainty about the future.

New steps in the management of financial wealth

Chart 5 Government Pension Fund Global

Norway invests a large proportion of its petroleum revenues in international equity, bond and real estate markets via the Government Pension Fund Global. The fund is fully integrated with the government budget, and the same priorities are imposed on spending from the Fund as on any other government spending. Today, the value of the Fund is around NOK 3.5 trillion, or about 170 percent of mainland GDP.

The Fund should be invested with a view to maximising future purchasing power. At the same time, investments must be diversified in order to reduce the risk of losses also during periods when markets are shrouded in fear and uncertainty.

Chart 6 The world's economic geography is changing

The world's economic geography is changing. While growth in advanced economies has been weak and is slowing, growth is robust in Latin America and Asia. Several countries in Africa are now catching up.

The Fund has considerable ownership interests in Europe. Its average holding in European companies is today around three times as high as in the Americas and Asia. The chosen regional distribution is related to Norway's import pattern and has been viewed as a form of currency hedging. But the result has been that a large proportion of the Fund is invested in a region that has experienced weak growth over the past decade. Analyses show that exchange rate risk in the Fund is relatively small and less than previously assumed. Based on these findings, the Norwegian Government has decided that the relative share of European investments should be reduced over time, so that the Fund's geographical diversification is further improved.

A more even distribution of the Fund's ownership will provide us with the opportunity to take part in value creation in regions with strong growth. This implies a reduction in the allocation to European equities and an increase in the allocation to the Americas and emerging economies. High economic growth in Asia may provide sound returns on investments in that region, even though today's equity prices already reflect expectations of higher growth in eastern than in western regions. A more even distribution will nonetheless improve the trade-off between risk and expected rewards.

Petroleum revenue spending

Norway as an oil nation stumbled at the start. The current account surplus at the end of the 1960s had reversed to a deficit of 12 percent of GDP by 1977. The deficit was three times as large as that recorded by Italy and Spain last year. The International Monetary Fund came knocking at Norway's door. Fiscal policy had to be tightened and many Norwegians experienced a decline in income.

Norway was hit by oil price shocks in the following years and economic reforms were implemented in several areas. After some years, the deficits had been turned into surpluses and transfers could be made to the Petroleum Fund.

Norway's experience from its first 30 years as an oil-producing nation led to the introduction of the fiscal rule, which has been a key element of Norwegian economic policy for the past decade. In 2001, the Storting laid down guidelines for the phasing-in of petroleum revenues into the Norwegian economy, establishing two main principles: economic policy must contribute to *stable economic developments and be sustainable over time.*

By linking petroleum revenue spending to the expected real return on the Fund – and not to current petroleum revenues – the fiscal rule provided for a gradual and sustainable phasing-in of the revenues. If we can restrict spending to the return, the Fund will never shrink in absolute terms. Norway will also be less vulnerable to fluctuations in current petroleum revenues.

The government has stated that the expected annual return on the Fund will be close to 4 percent over time. In the initial years, the actual return, adjusted for inflation and costs, was close to 4 percent. In recent years, with the financial crisis and the sovereign debt crisis, the real return has been lower, averaging about 2½ percent since 1998.

We should be careful about taking a rear-view mirror approach to forming expectations about the future. Equity prices fluctuate considerably and there is a possibility that the results of the past few years will be counterbalanced by good years ahead. But changes in the global economy affect the growth outlook and the balance of risks, and hence financial market returns as well.

Chart 7 Risk-free returns have fallen

The yield on the presumably safest long-term government bonds can provide a basis for estimating the return on the Fund. Returns exceeding this will reflect the risk we are willing to take.

In 2001, real interest rates on long-term government bonds averaged around 3 percent internationally. Real interest rates have since fallen and long-term real interest rates are now at a historical low of between 0 and 1 percent.

Over time, we expect equities to yield a higher return than bonds. Over the past few years, the Fund has increased its allocation to equities, compensating to some extent for low bond yields. However, the excess return on equities must be considerable to keep up the overall return on the Fund. This is not impossible, but perhaps more than we can expect. A bolder investment strategy could compensate for low interest rates, although the risk of substantial losses would also increase. This is not a path we are likely to take.

Table: Estimated real return

The fiscal rule was drawn up in 2001. Today, the situation is different. In 2001, a real return on the Fund of 4 percent, or a little higher, based on the then prevailing distribution between equities and bonds, was a reasonable assumption. Today, calculations yield a lower figure for expected real return. (1)

The real return on bonds in the Fund's portfolio can now be estimated at 1 percent. With a normal risk premium on equities, the real return on the whole Fund can be quantified at 3 percent. There is a possibility that the real return will be higher, but it may also be lower. If we spend more than the annual return on the Fund, we will be eating into the savings portion.

The conclusion is that a more robust approach would now be to base fiscal policy on an annual expected real return on the Fund of 3 percent. Such an adjustment would underpin the main principles that were behind the establishment of the fiscal rule – stability and sustainability.

Chart 8 Favourable timing for transition to 3 percent

In 2011 the structural non-oil budget deficit was about 3 percent, which is close to such a new path. Adapting petroleum revenue spending to a lower expected return should not therefore be particularly demanding. If we wait, a necessary policy adjustment later could be far more painful.

Monetary policy

Chart 9 Expected key rates

Central banks in other countries are deploying strong measures to buoy up economic activity and inflation. Key interest rates in many countries are close to zero. Central banks in the US, UK and Japan have made large-scale bond purchases and thereby expanded their balance

sheets in order to push down long-term interest rates. It is likely that the sharply expanded access to long-term liquidity from the European Central Bank (ECB) has reduced the risk of a banking crisis in the euro area. At the same time, ECB measures have contributed to stabilising government bond markets, and short-term funding costs for Italy and Spain have declined.

The EU is working on measures to restore financial market confidence – and public confidence. Greece has reached an agreement with its private creditors on a substantial debt restructuring. On this basis, euro area heads of state or government have approved a new loan package for Greece. Banks have been instructed to increase their core capital.

Chart 10 Two-speed development in Norway

The Norwegian economy is still well equipped to withstand the negative effects of the financial crisis. Oil prices are high, contributing to Norway's favourable terms of trade. Growth is being sustained by high activity in the oil industry. We have room for manoeuvre in economic policy. However, a number of enterprises are feeling the impact of the downturn abroad. Some segments of the export industry are feeling the effects of lower turnover and a strong krone. A high level of uncertainty is causing households and enterprises to be more cautious in their consumption and investment decisions. At the same time, house prices and household debt are still rising.

Capacity utilisation in the Norwegian economy is now near a normal level. Growth in mainland GDP is projected at about 3 percent this year and in the years ahead, broadly in pace with potential output growth.

Chart 11 Inflation

The operational target of monetary policy is annual consumer price inflation of close to 2.5 percent over time. Recently, inflation has been low, close to 1 percent. Inflation will be brought back to target, but how long this will take depends on the disturbances to which the economy is exposed and their effect on the prospects for the path for inflation and the real economy ahead.

When setting the key policy rate, we do not exclusively assign weight to bringing inflation back to target, but we also take into account the impact of the interest rate on output and employment. The inflation targeting regime is flexible.

By taking account of the deviation in the nominal interest rate from a normal level when setting the key policy rate, Norges Bank seeks to counter the build-up of financial imbalances that may disturb activity and inflation further ahead. This does not mean that the level of the key policy rate is an independent objective of monetary policy. Rather, the purpose is to overcome weaknesses in our analytical tools in order to cope with the possible build-up of financial imbalances resulting from keeping interest rates low over time.

Chart 12: Key policy rate in MPR 1/12

At our most recent interest rate meeting the key policy rate was reduced by 0.25 percentage points to 1.50 percent. In its assessment the Executive Board stated that: *"...weak growth prospects abroad and the strong krone are contributing to keeping inflation low and dampening economic growth in Norway (...). If the interest rate is set too high, the krone may appreciate further, inflation may continue to fall and growth in output and employment may become too low. This suggests that the key policy rate should be reduced further. On the other hand, there is virtually normal capacity utilisation in the Norwegian economy. Moreover, low interest rates over time may induce households and enterprises to take excessive risks and accumulate excessive debt."*

After a decade of learning, inflation targeting has become more flexible. The current outlook suggests that it will likely take several years before inflation is back on target. However, the inflation target has to be reached over time, otherwise our credibility is put at risk. Flexibility is good to have, and easy to lose. In assessing various considerations, monetary policy must be geared to meet its primary objective of low and stable inflation. There are limits as to how many goals monetary policy can meet. Other instruments must be used to attain other objectives. To ensure that new or further financial imbalances do not build up, we also need a tighter overarching international policy framework to address the stability of the financial system as a whole. A macroprudential policy framework should be part of this new framework.

Macroprudential policy framework

Financial market participants can trigger self-reinforcing economic fluctuations. Individual banks and investors do not necessarily take into account the overall risk in the financial system. The consequences became clear during the financial crisis: banks had inadequate equity capital, relied excessively on short-term wholesale funding and had insufficient buffers of liquid assets. The new international regulatory framework is intended to remedy this situation.

Stricter capital adequacy and liquidity coverage standards are in the offing. The authorities will also be able to tailor banks' capital requirements to the overall risk in the financial system. During upturns, these requirements can be raised, so that banks will have to hold more capital for their loans. This will smooth lending growth and better equip banks to bear losses during downturns.

The authorities must acquire tools that allow banks to be wound up in an orderly manner. Banks must also draw up plans for their own liquidation in the event of difficulties. Owners and creditors – not taxpayers – must bear the losses.

Politicians have the overriding responsibility for financial stability. It can be demanding to restrain credit growth in times of strong optimism and confidence in the future. Well defined mandates and a clear delegation of responsibility in the field of monetary policy has worked well. Similarly, the legal authority to implement macroprudential measures to safeguard financial stability should be delegated.

We can never fully insulate the financial system from shocks. But we can increase our resilience. One of the most important things we can do is to keep our own house in order – by preventing major imbalances from building up in the economy or in the financial system, and by ensuring that the financial system in general is robust.

Thank you for your attention.

Footnotes

(1) See Norges Bank Staff Memo 6/2012