Managing wealth – the Norwegian experience

Speech by Deputy Governor Jan F. Qvigstad at a seminar hosted by FEDEA in Madrid with the assistance of Norway's ambassador to Spain, Torgeir Larsen.

It is difficult to overstate the effects of the financial crisis that started in September 2008. As a financial crisis, it has been one of the most severe on record. The crisis in the real economy was even worse.
For the first time since the Second World War, total world output has fallen from one year to the next.

The crisis hit all countries and was surprisingly synchronised. This shows the interconnectedness of modern finance. Big banks have important parts of their operations in other countries, often on other continents. Some Spanish banks provide good examples.

Though the crisis hit us quite similarly, we have emerged from it in very different ways. The crisis was difficult to foresee, but was it possible - ex ante - to point out the countries that would end up in trouble after a crisis?

Norway has escaped this crisis more lightly than many countries. Luck explains a lot, but not everything. We had our own very serious crisis 20 years ago. One central instrument we put in place after that crisis was a fiscal rule. This rule is closely related to our sovereign wealth fund, the Government Pension Fund.

Many explanations are offered for the fall of the Roman Empire. Likewise, there are numerous causes behind the financial crisis. Greed, especially in the financial sector, stupidity, low lending standards and low interest rates have all been highlighted, and these arguments are not without merit. Still, two very important and striking features preceding the crisis were the growing imbalances in world trade and capital adequacy ratios in the banking system.

The crisis was preceded by a build-up of global imbalances. Large and growing deficits in the US were driven by high consumption and a large appetite for debt among US households. In the US, domestic spending had outpaced domestic production for a long period. Private debt increased in the US, but also in Europe, matched by high saving in Asia – primarily in China.

Federal Reserve Governor Ben Bernanke called the imbalances a global savings glut. This glut pushed down real interest rates and hence the return on investments. Low interest rates and compensation to take on risk led to a search for yield, increasing the inherent risk in the system.

Global trade imbalances have been reduced somewhat over the past two years, but there is a considerable risk that they will persist. They must be corrected through structural changes

in the real economy. This may weaken growth in the world economy in the coming decade. Asian economies, however, have fared well through the crisis. Emerging economies are now sufficiently large for growth in their economies to provide impetus to production in other regions.

The question has been raised, why didn't we – the economists – see the crisis coming? As long as the credit system has existed, crises have struck with irregular intervals. Still, we must strive to keep the intervals as large as possible. A poorly regulated financial sector is partly to blame for this crisis as for many others. In many countries, the capital requirements were reduced year by year before the crisis, to very low levels. The quality was gradually impaired. Many banks issued large quantities of hybrid capital, but the investors were not ready to bear losses.

In addition to low capital requirements, few countries had any macroprudential policies to speak of. Spain was an important exception. To avoid the next crisis, or at least dampen the effect, better banking regulation is necessary.

First, the financial crisis revealed that banks held insufficient capital, excessive short-term market funding and inadequate liquidity buffers. The new Basel III framework sets out stricter requirements. Higher and better-quality capital will increase banks' resilience to pronounced fluctuations in the economy without their having to tighten lending abruptly. The new rules aim to moderate growth in banking in periods of expansion.

Second, the new framework includes macroprudential tools that can be applied as necessary. Banks may be subject to additional capital requirements if credit growth in the wider economy is excessive. The requirement is intended to ensure that banks build up an extra capital buffer when systemic risk increases. Loan-to-value ceilings on mortgage loans may also be imposed.

On this point, the Spanish model of statistical provisions, introduced by Banco de España as early as 2000, has proved valuable. At the end of 2007, Spanish banks held as much as 1.3 per cent of total assets in these provisions, nearly a fourth of total regulatory capital.

Third, the authorities must acquire tools that enable banks to be wound up in an orderly manner. In this context, it is important that the structure of banking groups is transparent. Banks must also draw up plans for their own liquidation in the event of difficulties. Owners and creditors – not taxpayers – must bear the losses. The interest rate on banks' funding will then reflect the risk they take rather than an implicit government guarantee. This will in itself have a preventive effect.

The Basel Committee has decided on important measures. If countries are able to enforce new rules faster than the minimum standard of 2018, this should be welcomed.

Let me now turn to the mitigating policies; provisions to help societies through the crisis with as little human cost as possible. The crisis has been eased by active economic policy.

Monetary policy has been expansionary. Twenty years of low and stable inflation had provided confidence in central banks' ability to control inflation, which in turn had paved the

way for a sharp reduction in real interest rates without compromising the overall monetary policy target.

This contrasts with the downturn in the late 80s, as illustrated in the case of Norway, as well as during the Depression, when real interest rates were kept high due to faltering credibility.

Fiscal policy has also been used everywhere, and has prevented an even sharper fall in output. After two years of extensive fiscal measures, many governments are facing the wall. They are unable to finance further deficit spending and have to cut spending and increase taxes now.

The graph shows the increasing government deficit in the UK. The government has no choice but to tighten policy. The Swedish government, on the other hand, in spite of expansionary policies in the aftermath of the crisis, had maintained a surplus in the years before, and the Swedish economy has thus fared well.

Although countries were hit by the crisis in a fairly similar way, they emerged from it very differently. Some countries have experienced good growth rates and falling unemployment. Others are struggling to keep their head above water. Production is still far below the pre-crisis level, with unemployment hovering at record levels.

Are these differences predictable?

As a participant in OECD meetings for many years, I have sometimes been among the backbenchers, trying to check the pulse of the economy in various countries. I have developed a few simple rules for selecting variables to keep an eye on:

Over time, governments cannot run an increasing deficit. To prevent the debt level from exploding, the deficit must be kept in line with nominal GDP growth. That figure is around 4 per cent annually, for most Western countries.

A fiscal balance can hide important imbalances. If one sector in the economy is far too large, the taxes from this sector can contribute significantly to the fiscal budget. An example is the construction sector in some European countries in the years leading up to the crisis. In normal times, this sector is around 3-5 per cent of GDP in most countries. In Spain, housing construction was 9 per cent in 2006. In Ireland, the contribution was 11 per cent. When problems arose, construction activity decreased and tax income was reduced significantly. Therefore, one should also look at the current account.
Inflation above 4 per cent might indicate that price stability is not firmly anchored. If unemployment is above 4 per cent of the labour force, it might signal a labour market out of order. Finally, the risk of running into a crisis seems to increase if the total assets of the banking sector constitute more than 4 times GDP.

This table illustrates the 4 per cent rule. Many countries had negative fiscal balances through the last decade despite moderate to high economic growth. Spain seemed to be in a different position with a positive fiscal balance, though this was mainly due to unsustainable high growth in the construction sector.

This illustrates the first question, which is how to solve time inconsistency in fiscal policy. It is easier to follow the prescriptions of Keynes in bad times than in good times. This asymmetry may lead to an increase in budget deficits and sovereign debt over time, also referred to as the fiscal bias. As a result, many countries are forced to tighten policy in a period when the real economy would certainly benefit from further stimulus.

The crisis caused fiscal balances to deteriorate by 8-10 percentage points of GDP. There is an immense difference between encountering a shock of this magnitude from a positive fiscal balance of 4 per cent and encountering it from a negative fiscal balance of 4 per cent.

A similar time inconsistency problem, the inflation bias, has been a much debated issue in monetary policy. The solution has been central bank independence. The results have been fairly good.
The question remains, is there a lesson to be learnt in the fields of fiscal policy and banking regulation?

This crisis has been very benign to the Norwegian economy. One of the reasons, I believe, is that we had a national banking crisis only 20 years ago. Many of the executives in banks, corporations and government this time, had experienced the previous crisis. Hopefully, they had learned some useful lessons.

According to Kenneth Rogoff and Carmen Reinhart, the Norwegian banking crisis is in the top five list of the most severe banking crises in history, which also includes Spain 1977, Finland 1991, Sweden 1991 and Japan 1992.

Three of Norway's four biggest banks received capital injections from the government, after writing off the entire equity capital. The banks were fully nationalised. Two of them were later sold 100 per cent to private owners, while the government retained a large share (34 per cent) in DnB Nor. The banks had too little capital, as much of it was unable to bear losses. Therefore, the Norwegian definitions of Tier 1 capital were stricter than most countries.

Like many resource-rich economies, Norway expanded its welfare state rapidly after the discovery of oil. During the latter half of the 1970s, the government increased its ambitions in many key areas of the economy: the pension age was cut, agricultural subsidies increased, industrial policy widened and the government reduced taxes to bring wages under control.

The consequences were galloping inflation, a depreciating currency and worst, meagre productivity development in the Norwegian economy.

After 1986, steps were taken to get back on track. Interest rates were increased to subdue lending and the fiscal deficit was reduced. By 1990, Norwegian government believed a potentially upcoming crisis had been averted.

But Norway, like most European countries, was hit by the high interest rates following the German unification. A full blown banking crisis started in 1990, peaking with the nationalisation of the three main Norwegian banks in 1992. Unemployment in Norway rose rapidly and reached unprecedented levels.

The last two decades have been a golden era in the Norwegian economy. Partly thanks to sound macroeconomic policy and growth-stimulating structural reforms, we have experienced a strong growth record, after many years of meagre performance.

Due to good luck, we have also experienced very positive terms of trade developments. Increasing prices for our exports, such as petroleum, fish and aluminium, and decreasing prices for important import products like clothing and consumer electronics have made the average Norwegian much better off than he or she was twenty years ago. Norway's income has nearly tripled over the past 20 years.

It is often politically easier to introduce structural reforms during crises. When bad news fills newspapers and television programmes, the electorate is more likely to accept necessary measures.
In the long run, reforms prove to be very profitable even though they are painful in the short run. Among the changes in the Norwegian economy from the 1990s on were the removal of subsidies, closing down of government-owned enterprises, deregulation in important markets like housing and electricity, tax reform which increased incentives to work and closed tax evasion loopholes, and the reform of parliamentary budget procedures.

Finally, a fiscal rule was put in place, providing a sustainable relationship between the Government Pension Fund and the government budget.

The fiscal rule states that the government every year shall use the estimated long term real return on the Fund, set at 4 per cent. However, there is no direct link between petroleum revenues and the Fund. The government collects taxes from the whole economy, including the petroleum sector. After all government expenditures are paid, the surplus is transferred to the Fund.

The last 10 years, fiscal policy has been geared towards a cyclically adjusted non-oil deficit which corresponds to 4 per cent of the Fund every year.

Let me now turn to one very specific Norwegian issue: the management of our oil fund, called the Government Pension Fund Global. For the last 20 years, Norway has been a major petroleum producer. At the maximum, our nation produced about 4 per cent of global petroleum. This geological luck has given the Norwegian state an overwhelming cash flow.

The first money was transferred to the fund in 1996. Fifteen years later the Fund stands at NOK 3.2 trillion, or EUR 410 billion. It is probably the second largest sovereign wealth fund in the world. The Fund is now 120 per cent of Norway's GDP.

Norges Bank, as manager of this financial wealth, has laid down several governing principles for the Fund. We seek no controlling stakes. In fact, the maximum ownership in any one company is 10 per cent. We seek as good a return as possible, given the moderate level of risk defined by the Norwegian parliament and the Ministry of Finance.

Although government-owned, the Fund has no role at all in Norwegian foreign policy. The Fund is managed within an ethical framework. This framework has two pillars. Some companies are excluded from the investment universe, by the Ministry of Finance. And

Norges Bank has a corporate governance department which works together with the companies we invest in.

The overall principle for the investment strategy of the Fund is to keep a medium risk profile, defined by the Parliament and Ministry. Norges Bank makes investment decisions within this risk profile, to achieve as good a return as possible. As time has gone by and crises have emerged and subsided, the Norwegian parliament and public have increased their risk tolerance.

From the start, the Fund was invested alongside our foreign currency reserves, exclusively in government bonds with high liquidity, low risk and mediocre return. In 1998 we started investing in stocks, placing 40 per cent of the Fund in equity and keeping 60 per cent in bonds. In the following years, the investment universe was gradually expanded. Emerging markets were included, as were corporate bonds and stocks from small companies.

In 2007, the Norwegian parliament decided to increase the Fund's equity share to 60 per cent. Last year, we started investing in real estate. When the real estate target of 5 per cent is reached, bonds will constitute only 35 per cent of the Fund.

The Fund is invested broadly, with shares in 8000 companies world-wide and bonds from 2000 different issuers. The decision to increase the equity share in June 2007 took place just before the financial crisis started. Over the next two years, thanks to rebalancing and high oil prices, the Fund invested USD 150 billion in the world's equity markets.

The Fund now owns around 1 per cent of the world's listed stocks. In Europe, the ownership stake in the average listed company is close to 2 per cent. The Fund is overexposed in Europe, with more than half the fund invested here. The heavy weight for Europe was inherited from the management of foreign exchange reserves.

Going forward, a neutral weighting across regions may be warranted. There are good reasons for Norway to invest more heavily in countries far from us.

Since 1998 the return on the Fund has been a little disappointing. The fiscal rule is based on an annual real return of 4 per cent after costs. The realised return has only been 3 per cent. It is important to note that the period includes two large stock market crashes. The US stock market has gained zero over this period.

As I noted earlier, the Fund is invested mainly in line with market capitalisation – so called passive management. As a manager, we still have a mandate for active management to a certain degree. Our target is to generate an excess return of 0.25 per cent. We aim to achieve a return on the Fund which exceeds market returns by 25 basis points every year. Since inception, the excess return has been 31 basis points, a satisfactory result in our view.

The chart shows our major investments in Spain. We more than doubled our holdings of Spanish public debt during 2010. The reason was partly increasing returns, which made these investments more attractive. By the end of 2010, the Fund owned stocks in 80 companies listed on Bolsa de Madrid. The total value of these investments was EUR 5.6 billion. That is on a par with the benchmark portfolio.

That makes our Fund one of the largest financial investors in Spain. The fact that the Fund represents another country's government makes it important for us to be transparent, regarding both our targets and aims and our modus operandi.

The central point is the division between the government and the central bank. The government provides the rules, the central bank makes the concrete investment decision. Another is our mission to be a financial investor. We seek no strategic stakes. We do not sit on the executive boards.

Thank you.