The economic outlook

Address by Governor Svein Gjedrem to invited foreign embassy representatives, Norges Bank 2 April 2009.

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Excellencies, Ladies and Gentlemen,

Since our last meeting about a year ago, the international economic environment has changed dramatically. In my presentation today, I will focus on how the international downturn has influenced the Norwegian economy and the outlook for our economy. The crisis has its core in the financial system, and I will therefore discuss the need for a new international financial architecture. Finally, I will comment on the Government Pension Fund – Global and how the financial crisis has influenced its investments and returns.

Sudden global downturn in the real economy

In September 2008, the turbulence in financial markets erupted into a full-blown global crisis. On 15 September Lehman Brothers filed for bankruptcy. The next day, money markets seized up. Confidence between banks had been compromised. Liquidity dried up, interest rates rose sharply and equity prices fell. Exchange rate volatility – the daily fluctuations in the exchange rate – showed a marked rise. Bond markets in turn shut down. In the days and weeks that followed, banks tightened credit standards on new loans to households and enterprises.

Global economic growth was already slowing, but the situation deteriorated in the last few months of 2008. The turnaround hit hard, with synchronised effects on virtually all financial and goods and services markets, not only in the US but also in Europe, Asia, Latin America and Oceania. For a long period there were hopes that growth in China and other emerging market economies would hold up. But they are also now severely affected by the crisis.

The world economy is now in the deepest downturn in the post-war period, and will contract in 2009, for the first time in over 60 years. What is happening now is more than a normal fluctuation in the business cycle. The world is facing a crisis of confidence, with faltering faith in the future and a loss of confidence in banks, counterparties and contractual partners. The authorities have taken extraordinary action, as in a state of emergency, deploying a wide range of established and new policy instruments.

Banks have been nationalised and state ownership has increased. Central banks have cut policy rates substantially. Government authorities have employed credit easing and

quantitative easing to increase the money supply by purchasing private bonds and government debt.

Government authorities worldwide have increased budget deficits. In many industrialised countries, deficits will rise to about 5 per cent and for some as much as 10 per cent.

How the international downturn has influenced the Norwegian economy

Turning to the Norwegian economy, our export industry is being severely affected by the sharp global downturn, and this is having repercussions on other Norwegian business sectors. Mainland GDP is expected to fall by 1 per cent this year.

As in other countries, a wide range of instruments is being used to counteract the effects of the financial crisis. In order to curb the fall in activity, government expenditure will be increased by over 10 per cent this year.

Norges Bank's bank lending survey shows that banks have been tightening credit standards substantially, particularly for corporate loans. To boost the credit market, a separate government fund (1) will buy private bonds.
The government has also provided loans and guarantees for exports and expanded lending limits for the Norwegian State Housing Bank and other special vehicles for government financing (2).

At present, our banks are financially sound, but they need to strengthen their core capital in order to be able to supply credit as normal. The authorities are offering risk capital to banks, including core Tier 1 capital without voting rights, through a newly established State Finance Fund.

To facilitate the funding of banks operating in Norway, a swap arrangement was established allowing banks to exchange covered bonds for up to NOK 350 billion in government securities. A number of banks have made use of this facility, so far in an amount totalling NOK 90 billion. The arrangement provides banks with Treasury bills. Banks have used these as collateral for loans, sold them or kept them as liquidity reserves.

Norges Bank has also expanded its use of its ordinary instruments. We have supplied additional liquidity through our loan facilities and made arrangements for banks to furnish a greater range of securities as collateral for the loans. We have also provided loans with longer-than-usual maturities. The longest maturities have been two- and three-year loans, which have been geared to small banks.

Norges Bank has also supplied NOK through currency swaps and offered US dollar loans to Norwegian banks. Norges Bank entered into a swap agreement with the Federal Reserve, authorising a loan of up to USD 15 billion.

The measures have been effective. Money market rates, which for a period were above 8 per cent, are now approximately 3 per cent. In this period Norges Bank reduced the key policy rate by 3.75 percentage points to 2 per cent on 25 March. Banks' lending rates have decreased considerably. Credit flows have improved, but access to credit is still difficult for

enterprises. Money market premiums have fallen. In the first quarter of 2009, premiums on three-month interest rates in Norway stood at 1.2 percentage points. Norwegian money market premiums are expected to edge down ahead in line with premiums in global markets.

The global downturn led to a marked fall in prices for oil and other commodities through autumn 2008. Oil prices have for a period hovered around USD 40-50 per barrel. Oil futures prices have fallen and indicate an oil price of around USD 60 per barrel in 2010.

Other commodity prices that are important for the Norwegian economy have also fallen sharply. Metal prices are particularly sensitive to cyclical developments. Futures prices for a selection of raw materials indicate unchanged or moderately rising prices in the next few years. Many countries that have been hit by the economic setback will see an improvement in their terms of trade and growth in their disposable income.

The current downturn followed a period of very high global and domestic economic growth, supported by favourable trading conditions. Few countries benefited more than Norway from the economic upturn, which drove up prices for oil, gas and other export commodities. At the same time, an increasing number of cheap consumer goods were imported from new EU countries and from Asia. Norway's real disposable income increased by more than 40 per cent from 2002 to 2008, more than that of any other western country. But our terms of trade are now deteriorating. Some of the gains of the past few years have dissipated, and our disposable income might fall by close to 10 per cent in 2009.

In periods of substantial uncertainty, investors will seek to repatriate investments in foreign currency. The fragility of the Norwegian krone was illustrated when investors fled the currencies of small countries, and the krone weakened considerably. When speculators withdrew, daily fluctuations increased and hedging against exchange rate volatility became more expensive. The krone fell to a record-low level in December last year, but has appreciated since then.

Consumer price inflation reached a peak in October of 2008, but has slowed markedly thereafter and was 2.5 per cent in February. Underlying inflation is still above target and stood at approximately 3 per cent in February. Looking forward, inflation will abate.

Norges Bank has over a number of years focused on anchoring inflation expectations around the target of close to 2.5 per cent over time and has given weight to predictability, with a recognisable response pattern.

The downturn has not affected long-term inflation expectations to any great extent. According to an expectations survey, inflation expectations five years ahead among experts in the financial industry, the social partners and academia were virtually unchanged from the fourth quarter of 2008 to the first quarter of 2009.

After a prolonged upturn, both output and employment are falling in Norway. The turnaround had already occurred just over a year ago, but in the period to autumn last year, it appeared that capacity utilisation would gradually decrease to a normal level. As the global economic outlook deteriorated, it became clear that the slowdown in our economy would

occur more rapidly and be more pronounced than envisaged earlier. In November, regional network contacts reported an abrupt and marked turnaround in activity. They now report that the labour supply is no longer a constraint on production. The enterprises in the network are expecting output and employment to fall further over the next six months.

Unemployment has increased since autumn last year, but is still at historically low levels. Unemployment is projected to rise to almost 5 per cent at the end of the year. Wage growth is expected to come down this year from a high level in 2008. Lower corporate profitability, rising unemployment and lower consumer price inflation will probably result in low negotiated pay increases this year.

The export sector has been particularly hard hit by the global downturn. Traditional exports have fallen markedly since autumn last year. A contraction in the world economy will result in a substantial decline in Norwegian exports ahead. Moreover, due to the marked fall in commodity prices, export prices are now very low. A weak krone may help to maintain profitability in Norwegian export enterprises.

Expensive and reduced access to credit, high interest expenses and uncertainty about developments ahead amplified the downturn towards the end of 2008. Private consumption fell markedly, the decline in housing investment accelerated and mainland business investment started to fall. The downturn in the world economy and the abnormal conditions in financial markets are expected to continue to mark the Norwegian economy ahead. Mainland GDP is projected to contract by 1 per cent between 2008 and 2009.

Norwegian government finances are sound, with substantial net wealth, although the surplus will be reduced by the fall in oil prices. The automatic stabilisers in the national budget together with discretionary fiscal policy will stimulate the mainland economy by the equivalent of 5 per cent of GDP from 2008 to 2009. Fiscal policy is assumed to become less expansionary between 2010 and 2012. Government oil revenue spending is expected to be brought back into line with the fiscal rule when cyclical conditions eventually normalise.

We assume that prospects for higher unemployment, a fall in house prices and a high level of debt will induce households to build up financial buffers and reduce debt. The saving ratio is expected to increase considerably. Net lending is projected to be positive this year after being negative since 2004. As household borrowing has been considerable in recent years, deleveraging in the household sector is important to long-term stability in the economy.

The outlook ahead and monetary policy assessments

Inflation will be curbed by lower capacity utilisation. The marked increase in unemployment now envisaged will result in lower pay increases this year and next.

Prospects for weaker growth and lower inflation imply a lower interest rate than presented in the interest rate projection from our previous forecast in December. There is also a risk that the global downturn will be deeper and more prolonged than expected. If this proves to be the case, growth in the Norwegian economy will not pick up as quickly and inflation will fall more sharply than we currently assume. The objective of avoiding a pronounced

downturn indicates in isolation that the interest rate should be rapidly reduced to a low level.

On the other hand, we have already made substantial reductions in the key policy rate. With a low interest rate, households may save less and the turnaround may occur more rapidly than we assume. This indicates in isolation that changes in the interest rate should be gradual or that further interest rate cuts should be put on hold.

Overall, the outlook and balance of risks suggest that the key policy rate should be gradually reduced further to a level of around 1 per cent in the second half of 2009. This is about 1 percentage point lower than in Norges Bank's forecast from 17 December last year.

With the low interest rate added to government fiscal measures, our analysis indicates that growth in the economy will be positive from the second half of this year. Growth will be driven by a rise in private consumption as a result of a low key policy rate, growth in real wages and higher government transfers. Activity in the economy will be boosted by strong growth in government spending. The projections are based on the assumption that Norges Bank's interest rate changes will translate into lower lending rates for households and businesses. At the same time, owing to tighter credit standards in banks, monetary policy appears to be somewhat less effective than normal.

Inflation is projected to fall below 2 per cent in 2010, before gradually moving up towards the target towards the end of the projection period as the output gap gradually closes. There is a risk that the structural changes brought about by the crisis may result in persistently lower productivity growth and perhaps higher unemployment.

It appears that inflation will remain considerably lower in the years ahead than we expected in December. Both the objective of stabilising inflation around the target and the objective of ensuring stable developments in the real economy suggest that the interest rate should be low.

Financial architecture

In many countries, banks' share of GDP has increased considerably over the past few years. This share is smaller in Norway than in other countries and, as a result, the Norwegian economy has been less exposed to the financial crisis. Although banks in Norway have not been as oversized as in many other countries, banking still contributes to fluctuations in our real economy.

Banking is procyclical. In upturns, loan losses are low, increasing banks' profits. Access to equity capital is ample, providing the basis for strong lending growth.

Losses increase in downturns, and the supply of equity capital can dry up, compelling banks to restrict their lending. The impact is stronger since the value of property used as collateral fluctuates in step with cyclical developments. At the same time, counterparties and rating agencies may require higher capital levels. When credit is rationed by banks with large market shares, in regional or national terms, sound investment projects are also postponed.

This results in an adverse feedback loop, with banks incurring higher loan losses and weaker earnings – as economic activity stalls.

Banks operate with very low levels of equity capital. A manufacturing enterprise or a firm in the service sector should preferably have an equity ratio of between 30 and 70 per cent, depending on the level of risk involved. Banks can operate with a far lower level of equity capital because they are supposed to diversify risk, have sound management systems and be well regulated and under supervision.

In Norway, banks' equity capital makes up six per cent of their assets. Before the Second World War, the ratio was over 10 per cent, falling to five per cent in the post-war period. Government capital injections resulted in a rise in equity capital at the beginning of the 1990s, but the ratio has fallen again in recent years.

Equity capital in investment banks in the US and Europe was very low, as low as 2-3 per cent of total assets. Many of these banks have now collapsed.

The authorities in many countries are working to enhance financial market resilience. Three changes are particularly relevant for the Norwegian banking sector:

First, for a given risk assessment, capital requirements must be higher.

Second, banks must not be allowed to reduce capital below a minimum level even if they extend loans that, according to models, seemingly involve low risk.

Third, banks must build up strong capital buffers over and above the minimum requirement in normal times. Then banks would not have to increase capital when the turnaround occurred. On the contrary, they would be able to absorb losses, thereby avoiding the need to ration credit in bad times.

Norwegian banks do not have sufficient buffers today to safeguard their own, their shareholders' or the economy's best interests. That is why the government is now supplying risk capital. There should be no doubt that banks have the capital they need.

In addition, banks' funding methods make them vulnerable. Earlier, Norwegian banks primarily obtained funds through deposits by households and enterprises. In recent years, banks have borrowed heavily in both domestic and foreign markets. During the crisis, this proved to involve high liquidity risk for banks. Long-term credit markets have now dried up. The government and Norges Bank have therefore taken on the role of lender. In the future, in regulations and in practice, deposits must again take precedence as the largest source of funding for banks. Bonds collateralised by high quality mortgages, so-called cover bonds, will probably also be important.

The G20 group is now discussing how to tackle the crisis and prevent it happening again. It will be important to avoid protectionism and trade wars.

Moreover, the ambition is to establish a new and more sustainable financial architecture.

Markets are integrated and banks are global, while the supervisory authorities are national and the application of rules varies. Supervisory authorities must be strengthened and adopt a uniform approach to banks, and regulations must be improved. There has been some competition between countries to establish national financial centres. This has had an impact on national supervisory authorities, who have therefore tended to be reluctant to impose stringent requirements on the banking sector. It is important to avoid slippage in the rules towards an agreed minimum level that is too low. For Norway, it is essential that rules are applied stringently and uniformly in all the Nordic countries since banks based in Sweden and Denmark have large market shares in Norway and Norwegian banks have ambitions in Scandinavia.

In recent years, there has been little cooperation across countries in the field of macroeconomic policy. The view has been that all is well as long as each country keeps its own house in order. This is an important point of departure, but we have now presumably learned that imbalances and risk arise when large countries do not sufficiently take into account that their own choices also influence those of others.

The International Monetary Fund (IMF) must be given a more important role. The Fund must enhance its surveillance activities and its advice must be acted upon to a greater extent. However, this probably requires changes in the IMF's governance structure. Countries that are now gaining in economic strength are seeking greater influence, and the IMF must also improve its reputation in these countries. We have to ensure that the Fund has sufficient resources to grant loans to member countries that are particularly hard hit by the financial crisis. The financial resources of the IMF are being discussed at the G20 summit in London. The IMF aims to double its lending capacity and has called on member countries to provide the necessary funding. Several countries have responded positively, among them Norway. The Government has offered to make available a contribution of up to NOK 30 billion to the IMF, subject to approval by the Storting. The US has asked for the NAB (3) to be increased substantially. Even a special one-time allocation of SDRs (4) to strengthen global liquidity may be considered.

The Government Pension Fund – Global

Let me now turn to the Government Pension Fund – Global.

International capital markets have been a boon to Norway. We drew on borrowing opportunities abroad when the petroleum industry was being built up. We did the same in order to expand welfare schemes and to finance the countercyclical policy of the mid-1970s and the early 1990s. National oil and gas resources are now converted into equities and bonds abroad in the Government Pension Fund –Global.

The Pension Fund was formally established in 1990, but it was not until 1996 that the first allocation – NOK 2 billion – was made. 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. This means that all Norway's petroleum revenues, as well as the return, go into the Fund. Then, as part of the budget resolution, the Storting decides on an annual transfer from the Fund to cover the government budget deficit. This procedure

effectively prohibits use of the capital in the Fund for purposes not considered sufficiently important to be prioritised in the regular budget process. High oil prices led to record-high inflows of capital into the Fund of NOK 384 billion in 2008. The Fund's market value was NOK 2 276 billion at the end of the year. The Ministry of Finance has decided to increase the allocation to equities in the Fund from 40 to 60 per cent.

The financial crisis has dealt a blow to our investments in global equity and fixed income markets. The annual real return since Norges Bank commenced the operational management of the Fund is now just 1 per cent, which is well below the assumed long-term return of 4 per cent. The Fund has not reaped a risk premium in the equity market as we had expected. During the same period, considerable revenues have been generated from the exploitation of petroleum resources. Global capital markets give us an opportunity to distribute the spending of these revenues across current and future generations. There are no other options for investing this wealth that could have shielded the Fund from the global economic downturn. Other government assets, such as shareholdings in domestic industries and subsea resources in the North Sea have also fallen sharply in value, at market prices. Real household housing wealth has also declined since summer of 2007 to the end of 2008.

The return on the Government Pension Fund – Global generated in 2008 was 3.4 per cent lower than that on the benchmark portfolio. This is considerably lower than expected in the light of our investment strategy, which features a large number of small and independent positions. This performance was due primarily to the investments in the fixed income portfolio, which proved to be less well-diversified than expected, and to investments that exposed us to changes in liquidity premiums.

The Fund currently has extensive holdings of bonds, that despite high ratings, are difficult to trade in today's market. Realised losses have been limited. The flipside of large book losses is that this portfolio has a high yield, reflecting not only the increase in credit risk but also high liquidity premiums and fears and uncertainty in the market. History has seen a number of deep financial crises, and market conditions will return to normal in time. The true value of the bond portfolio will, at the very latest, be realised when the loans are repaid. More than 90 percent of the fixed income portfolio is rated A or better. Even though rating agencies do not always prove to have the best evaluations, this still illustrates our conservative investment strategy.

The Fund is a long-term savings plan and capable of riding out large swings in the markets. This is the very foundation of the investment strategy with its high allocation to equities. Our ability to adhere to this strategy in a critical phase – even if this should persist for some time – is crucial if the Fund is to deliver the returns we expect in the longer term. We need to attach importance to the real value of equity investments and safeguard assets by spreading the Fund's investments. Norges Bank therefore supports the strategy that the government has chosen for the Fund.

Under the Fund's strategy, more equities will be bought when equity prices fall and fewer when they rise. The Fund therefore purchased a large volume of equities from 2001 to 2003 and is buying a considerable volume now. Of the equities now owned by the Fund, 40 per cent were purchased last year when prices were moving down.

As a result, ownership in the business sector in the US, Europe and Asia has increased – in companies' human capital, in their machinery and equipment, brands and organisation. The Fund now has holdings in almost 8000 companies and owns approximately 0.77 per cent of global equity markets. In the long run, and even though many companies have now folded, investing in companies may perhaps be at least as safe as extending loans.

Thank you for your attention

Footnotes

1) Folketrygdfondet will manage the new Government Bond Fund

2) The Government has increased the capital of Kommunalbanken Norway (the local government funding agency), it has increased the scope of GIEK (the central government export credit agency) and Innovation Norway, and has offered state loans to Eksportfinans Norway (the credit institution for export financing)

3) New Arrangements to Borrow

4) Special Drawing Rights