The Norwegian economy and financial stability

Speech by Deputy Governor Jarle Bergo in London on 7 November 2006

The text below may differ slightly from the actual presentation. The speech is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 1 November and Inflation Report 3/06.

First of all, let me tell you how pleased I am to be here with you at the Norwegian Savings Banks conference in the great city of London, and to share with you some views on the Norwegian economy and financial stability.

I shall structure my presentation as follows: First some stylised facts on our two economies, then set out the special challenges to a small, open, oil-rich economy. Next, I shall comment on the current economic situation and the prospects before I turn to financial stability issues.

Now, about our countries: The UK and Norway enjoy strong and close relations, not least trade relations and we have done so for centuries. Our first bilateral free trade agreement was signed between King Henry the third and King Håkon Håkonsson in 1223. Today the UK is our single largest export market and the fourth largest supplier of Norwegian imports.

We are also bound together by a common sea. We have developed our petroleum resources largely in parallel. The opening of a new gas pipeline from mid-Norway to Easington - Langeled - in October this year is yet another example of the tight bonds between us.

Comparing our two countries we find strong similarities - both are affluent, growing briskly, and experiencing low unemployment. Both are open economies with a significant public sector. The UK economy is, however, nearly eight times larger than the Norwegian economy and with a very large and well-developed financial sector, while Norway on the other hand has a much larger oil sector.

Challenges in an oil economy

Norway ranks as the world's third largest oil exporter after Saudi Arabia and Russia and the eight largest oil producer.

Petroleum activities have contributed substantially to Norway's GDP, exports and government revenues since the late 1970s. Petroleum activities give Norway an economic base that is not available to many other countries.

But oil and gas also present Norway with considerable economic policy challenges. The experience of other countries that have received large, unexpected income from natural resources is not encouraging. Societies that suddenly gain access to huge wealth stemming from natural resources have a tendency to spend the money and then fall into decline.

Spain in the 17th century provides a good example of this, as the historian David Landes observed.[1] The colonisation of South and Central America gave access to a wealth of natural resources, not least gold. Spain chose to spend a large portion of the windfalls on luxury and war. More recently the expression "Dutch disease" reminds us that this issue is still relevant.

It can certainly be argued that easy money is bad for a country. It is tempting to live comfortably on this income - which actually is not income but drawing on wealth - while it lasts, and forget about and be less concerned about safeguarding other revenue sources. The challenges with large income from natural resources and its negative impact on economic growth have also been pointed out by Jeffrey Sachs and Andrew Warren.[2]

Success in managing our petroleum wealth may be particularly dependent on four key factors.

First, from a long-term perspective, oil and gas production will take place during a limited time period. When oil is extracted and sold, petroleum wealth is transformed into financial wealth. This wealth belongs not only to our generation, but also to future generations. We must therefore manage the wealth as an asset.

Second, the size of the cash flow from petroleum activities varies considerably from year to year. If it were to be spent as it accrues, this would lead to strong cyclical fluctuations in the Norwegian economy.

Third, in terms of economic policy, an explanation for "the resource curse" has been that such "un-earned" wealth leads to an extreme focus from various groups on acquiring as much of this extra wealth as possible. It is therefore important that the decision-making processes in the political sphere guard against this kind of "rent-seeking" behaviour.

Finally, petroleum revenue spending will have a serious impact on the competitiveness of Norwegian industry if spending is too rapid and variable. It is therefore important that we succeed in maintaining an industry structure that promotes learning, innovation and development, which can give us other sources of revenue than oil.

What we are trying to achieve is to transform petroleum wealth into financial wealth, to the benefit of future generations as well.

Nonetheless, the discounted value of our own labour force is our main asset. Our livelihood essentially depends, and will continue to depend, on our ability to efficiently produce goods and services and to use our creativity and innovation to become ever more efficient.

Economic policy guidelines

During the first thirty years of the oil age, economic fluctuations, often linked to oil revenue spending, were strong. Against this backdrop and increasing demands for spending more, new economic policy guidelines were adopted in 2001.

A fiscal rule was drawn up for petroleum revenue spending over the central government budget. Government petroleum revenues are transferred to the Petroleum Fund, now renamed the Government Pension Fund - Global. The Fund serves as a buffer between current petroleum revenues and the use of these revenues in the Norwegian economy. According to the fiscal rule, future petroleum revenue will be added to the Fund while spending shall be limited to the expected real annual return on the Fund, estimated at four per cent. When all the petroleum revenues have been extracted, the Fund would grow no further, but its value in real terms would be maintained - in principle for eternity. This ensures an equitable distribution of the petroleum wealth across generations.

The fiscal spending rule partly insulates the economy from fluctuations in the petroleum sector - and when followed it ensures that revenue spending is at a level that can be sustained over time. The difference between the net cash flow and spending is reinvested in foreign financial markets. Norges Bank manages the Fund, and our London office plays a pivotal role in the investment activities.

The Pension Fund also functions as a buffer and dampens the wide fluctuations in the krone exchange rate that petroleum revenue inflows might otherwise have generated. The Fund is invested solely abroad, thus acting as a kind of "revolving door" for currency inflows from petroleum activities.

With the fiscal rule, it was recognised that the most important contribution fiscal policy can make to stabilising the Norwegian economy is to provide a sound, long-term strategy for petroleum revenue spending.

As a consequence, monetary policy had to take responsibility for smoothing the business cycle to a greater extent than earlier. A specific target for monetary policy was thus a necessary supplement to the fiscal rule to ensure reasonable macroeconomic stability. The operational target states that monetary policy in Norway is oriented towards low and stable inflation, with annual consumer price inflation of approximately 2.5 per cent over time. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment.

Current economic situation

Since the summer of 2003, there has been a clear upturn in the Norwegian economy. Low domestic interest rates, increased petroleum investment, favourable prices in important export markets, and a strong upturn in the world economy have contributed to solid growth in the Norwegian economy. So far in the upturn, the mainland economy has grown by an average of close to 4 per cent annually.

Current information on economic developments indicates that the upswing is continuing. Corporate sector profitability is good. There is strong growth in employment, unemployment has fallen markedly, and household demand continues to rise.

Unemployment is now at a historically low level. Seasonally adjusted, registered unemployment stood at 2.3 per cent of the labour force in October.

Nevertheless, wage moderation has generally prevailed so far. The opportunities provided by an international labour market may have prompted participants in local and centralised wage negotiations to place greater emphasis on the considerably higher wage level in Norway relative to our trading partners, and potential job vulnerability. At the same time, labour migration has reduced bottlenecks in some industries allowing the economy to expand more briskly than would seem warranted judging by previous experience.

Inflation has remained low. According to our indicators underlying inflation appears to be in the range of ¾ - 1½ per cent. Low underlying inflation is not a result of weak economic growth but rather reflects favourable developments on the supply side of the economy. Strong competition, high productivity growth, and a shift in imports towards low-cost countries have dampened domestic price increases.

Presently, there is little spare capacity in the Norwegian economy. Demand is still strong and real income growth high. At the same time, the krone exchange rate has depreciated. This should over time result in a pick-up in inflation.

The global economy has shown strong growth, and continued solid growth among our trading partners is in prospect. However, there is uncertainty regarding the slow- down in the US economy. Consumer price inflation among a number of our trading partners has risen as a result of rising energy prices, but the increase in prices for other goods and services generally remains moderate.

Monetary policy

The challenge to monetary policy in the present conjuncture is how the interest rate should be set to steer inflation towards the target while at the same time avoiding overheating in the real economy.

Central banks influence over-night market rates directly via the policy rate. However, economic agents' consumption and investment decisions depend more on their interest rate expectations. Hence, monetary policy works primarily by influencing expectations regarding future interest rates. Monetary policy may thus be more efficient if economic agents understand the central bank's intentions in its interest-rate setting.

In the November 2005 *Inflation Report*, Norges Bank first published its own forecast for the interest rate for the next three years. The aim is to enhance the predictability of monetary policy. With a predictable monetary policy, market participants can react to new information in a way that contributes to stabilising developments in output and inflation.

We try to establish an interest rate path that provides a reasonable balance between the objective of stabilising inflation at target and the objective of stabilising developments in output and employment within a reasonable time horizon, normally 1 - 3 years. Interest-rate setting is also assessed in the light of developments in property prices and credit.

The results of this trade-off are published in the *Inflation Report* in the form of a chart that presents central projections for the interest rate, the exchange rate, inflation and capacity utilisation in the economy.

Underlying inflation has been lower than projected in recent months. Nevertheless, several factors point to higher inflation ahead. Capacity utilisation is high and there is little spare capacity in the Norwegian economy. Employment is rising rapidly and unemployment has exhibited a marked decline. There are signs of higher wage growth and expectations of rising inflation. At the same time, the krone exchange rate has depreciated from strong values.

Monetary policy influences the economy with a lag. Over several years, interest rates have been considerably lower than what we consider to be a neutral level. Against the background of high growth in output and employment, rising wage growth and a weaker krone, there are prospects of higher consumer price inflation ahead. The interest rate may gradually be raised to a more normal level at a somewhat faster pace than envisaged earlier, although it is unlikely that rates will be raised at every monetary policy meeting. Based on our current assessment, the interest rate will thus continue to be raised in small, not too frequent steps.

The forecasts are uncertain. They are based among other things on an assessment of the current situation and a perception of how the economy functions. Disturbances to the economy may result in changes in the forecasts. Frequent data revisions imply that the current economic situation is not fully known. The chart illustrates the uncertainty surrounding the forecasts. The wider the fan chart is, the more uncertain the forecast. The uncertainty implies that the interest rate should normally be changed gradually, so that we can assess the effects of interest rate changes and take into account new information about economic developments.

Changes in forecasts are nothing new to financial market participants. There is no reason to believe that Norges Bank will not also have to reassess its interest rate and other forecasts as new information emerges about economic developments. Our ambition must be to reduce uncertainty with regard to our own response pattern.

Financial stability and monetary policy

Financial stability means that the financial system is robust to disturbances in the economy and is able to channel funding, execute payments and redistribute risk in a satisfactory manner. Experience shows that the foundation for financial instability is laid during periods of strong growth in debt and asset prices. Banks play a central part in providing credit and executing payments and are therefore important to financial stability.

Monetary and financial stability are both important for economic developments. In my view, they are often mutually reinforcing.

Financial stability can be seen almost as a prerequisite for price stability. First, it promotes stable developments in financial markets, which is crucial to balanced economic growth. Second, financial stability supports the transmission mechanisms of monetary policy.

Conversely, price stability has a positive influence on financial stability. A successful monetary policy will support financial stability by removing distorted price signals associated with high and volatile inflation. Low and stable inflation provides households and enterprises with a clear indication of changes in relative prices, enabling them to make better informed decisions. Allocation of resources will then be more efficient.

The Norwegian financial system and its soundness

In Norway, responsibility for financial stability is divided between Norges Bank, Kredittilsynet (the Financial Supervisory Authority of Norway) and the Ministry of Finance. To promote efficient cooperation, the regular exchange of information between these authorities is crucial and a framework for cooperation has been established.

Kredittilsynet is responsible for supervising individual financial institutions, while Norges Bank analyses the stability of the financial system from a macro perspective, aiming at identifying developments that may lead to the build-up of excessive risk in the financial sector and the build-up of financial imbalances that may pose a threat to financial stability. Norges Bank also has special responsibility for the clearing and settlement systems and inter-bank payment systems.

Should a situation arise where financial stability is threatened, Norges Bank and other authorities will, if necessary, implement measures to strengthen the financial system. Norges Bank may supply extraordinary liquidity to individual banks or to the banking system as a whole but only against proper collateral. The Ministry of Finance will be responsible for decisions where use of tax-payers' money would be an issue.

Norges Bank publishes an overall assessment of the outlook for financial stability in the biannual *Financial Stability report*. The conclusions in the report are summarised in a submission from the Bank's Executive Board to the Ministry of Finance. The report is also intended to foster dialogue with the financial industry and to increase awareness of and foster debate on the importance of financial stability.

Norges Bank has also developed a macroeconomic model to assess developments in financial stability based on the forecasts published in the Bank's *Inflation Report*. Based partly on the results from this model, financial stability assessments are taken into account in the monetary decision-making process.

Before I turn to our most recent assessment of the stability of the Norwegian financial system, let me give a brief outline of the structure of the financial system.

The Norwegian financial system is dominated by banks, with a market share of more than 56 per cent, calculated as the banks' share of total assets in financial institutions and mutual funds. The banking system is relatively concentrated. The largest bank had a market share of 37 per cent in terms of total assets in the banking sector at the end of 2005, while the largest five had a market share of 61 per cent.

Savings banks account for a substantial part of the banking sector. However, most of the savings banks are quite small. To partly compensate for that, some cooperate on a range of products which provides economies of scale while maintaining their independence.

During the past decade, activities of foreign-owned banks in Norway have expanded considerably both through take-overs and organic growth. At the end of 2005, they had a market share of over 30 per cent, in terms of total assets. Their lending growth has been higher than for Norwegian-owned banks for several years. The development towards larger cross-border banks makes supervision and crisis management more complicated. In the event of a crisis, central banks, supervisory authorities, political authorities as well as deposit guarantee funds in several countries will have to be involved.

In contrast to the balance sheets of the banking sectors in many other countries, Norwegian banks' total assets are heavily dominated by loans to households and non-financial enterprises. One reason for that might be the lack of securitisation of loans. The work on regulations that will enable securitisation of loans is in progress. Loans to households alone constitute around 50 per cent of banks' total assets. Loans to households have increased as a percentage of banks' total assets, reflecting strong credit growth to households.

Norwegian banks' main source of financing is deposits from households and non-financial enterprises. Securities are the second largest source of financing.

Assessment of financial stability in Norway

In 2005, the International Monetary Fund (IMF) prepared a thorough assessment of the financial system in Norway under the Financial Sector Assessment Program (FSAP) for Norway. The main conclusions were that the system appeared sound, well managed and competitive, and shorter-term vulnerabilities appeared low overall. Beyond the shorter term, rising household debt levels and associated house price inflation were the most important potential risk factors that needed to be watched.

Let me add some observations on this last topic. Unlike many other countries, house purchases in Norway are mostly financed by loans from private banks at variable interest rates. Growth in credit to households has been high for a relatively long period, largely driven by rising house prices. According to our model, a rise in house prices has a strong and prolonged effect on household debt, as it takes time before all dwellings have been traded at the new higher price level. Growth in credit to households can therefore remain high for quite some time, even if the increase in house prices should start to subside.

What then is driving house prices? In our empirical model, house prices are determined by household income, banks' lending rates after tax, the housing stock, unemployment, and an indicator of household expectations of their future financial situation and of the Norwegian economy as a whole.[3] Household income has contributed most to the rise in house prices in the last two years. Interest rates have increased since the summer of 2005. Given the lags involved, the cumulative contribution from interest rates to house prices is still positive. Nevertheless, in the period ahead, the normalisation of interest rates in Norway may moderate the rise in house prices.

Observations from other countries, such as the UK and Australia, indicate that a rise in the key interest rate by the central bank has been followed by slowdown in house prices.

Growth in household debt has been higher than growth in disposable income for several years now. The household debt burden (household debt as a percentage of disposable income) has increased to a historically high level and is expected to rise further. However, the household interest burden (interest expenses after tax as a percentage of disposable income plus interest expenses) is still low as a result of the low interest rate level. The interest burden is expected to increase to fairly high levels in pace with a normalisation of the interest rate. Still, on the whole, households' financial position is strong.

The rise in the policy rate so far has not been fully reflected in banks' lending rates. Intensified competition, especially for mortgages, has dampened increases. Banks' interest margin has declined during the last decade.

Falling interest margins have, however, partly been compensated by high lending growth, and banks have so far succeeded in maintaining good results. Pre-tax profits as a percentage of total assets have been solid.

Norwegian banks are solid. Due to high growth in lending, capital adequacy ratios for banks as a whole declined slightly in 2005. Nevertheless, capital adequacy ratios are still high.

Under Basel II, capital requirements for credit risk are to be calculated using either the standardised approach or more risk-sensitive internal ratings based (IRB) approaches. The five largest Norwegian banks have applied to Kredittilsynet to use the Foundation Internal Ratings Based (FIBR) approach for credit risk. Under Basel II, the required level of capital for banks in Norway will be reduced. The main reason is that mortgages constitute a substantial part of banks' total assets. These loans are considered low risk under Basel II. The reduction in the required level of capital may be substantial for the banks using IRB approaches for credit risk, though transitional arrangements provide for a gradual reduction.

With solid results in banks, a good financial situation for borrowers and a well functioning financial infrastructure, there appears to be little risk of a crisis in Norway's financial system in the next few years. However, the long period of strong debt growth and asset price inflation may be a source of subsequent instability in the economy and in banks' losses and results. During an upturn such as the current one, it is therefore important to show vigilance and provide a cushion for weaker cyclical conditions and higher interest rates. Within the framework of Basel II, banks that shift to internal risk models based on historical losses for measuring capital requirements should take into account that loan losses have been unusually low in recent years.

Banks are vying for market shares. Competition is fostering more cost-effective banks, better and more flexible borrowing terms and a broader product range. This is to the benefit of customers. At the same time, it is important that banks price risk correctly. This enhances capital efficiency and promotes financial stability.

Thank you for your attention.

Footnotes

[1]David Landes (1998): The Wealth and Poverty of Nations, W.W. Norton & Company, Inc., N.Y.

[2]See e.g. J.D. Sachs and A.M. Warner (2001): "The curse of natural resources", *European Economic Review* 45, pp. 827 - 838.

[3]D. H Jacobsen and B.E. Naug (2005): "What drives house prices?", *Norges Bank Economic Bulletin*, no. 1/05, pp. 29-42.