The global economy and Norwegian monetary policy

Address by Central Bank Governor Svein Gjedrem. The Southern Norway Conference, Kristiansand, 6 March 2001

Over the past few centuries, Norway has been transformed from one of the poorest countries in Europe to one of the richest, thanks to its profits from international trade. Foreign capital was important for the utilisation of Norwegian natural resources.

Cross-border capital flows have increased sharply, particularly in recent years. The chart shows Norwegian inward and outward direct investment. These are strategic investments involving ownership interests of 10 per cent or more, unlike portfolio investments that normally involve small stakes. Norwegian companies' direct investment came to NOK 74 billion last year. The figures were boosted by substantial acquisitions abroad by Telenor and Norske Skog. Over the past two years foreign companies' investment of this type in Norway came to around NOK 100 billion. Over time, Norwegian acquisitions abroad and foreign acquisitions in Norway are more or less balanced.

The state is accumulating substantial foreign assets through the Government Petroleum Fund. As result of these investments, Norway is in a net asset position vis-à-vis abroad. In addition Norwegian insurance companies and securities funds have markedly increased their foreign investments in recent years. At the same time, Norwegian banks finance a large share of their lending through foreign capital, and foreign investors are steadily increasing their share of Norwegian securities holdings. What we are seeing is a sharp increase in private holdings of assets both in Norway and abroad. This constitutes the core of globalisation. Capital finds its way to the highest return irrespective of national borders.

Challenges posed by a global capital market

The Norwegian capital market is part of a Nordic market, which is being increasingly integrated into an international capital market. Capital markets are a very efficient tool for channelling funds from savers to investors. Capital markets act as a catalyst for restructuring and growth, but also for financial bubbles and crises. This places new demands on economic policy.

If a country is to benefit from a free capital market, it must draw up legislation providing for regulations and supervision that ensure stability. Countries with poorly developed capital markets may benefit from some limitations. They should exercise some caution in opening these markets too suddenly. The flow of capital is like electricity. Adequate insulation should be in place before it is turned on.

When the Nordic countries liberalised credit markets in the 1980s, we experienced considerable problems because supervision and rules were not adequate. The same was witnessed in the crisis in Asia and Russia a few years ago. Inadequate and ineffective legislation and supervision resulted in weak control of financial sectors in the beleaguered countries.

The liberalisation of the capital market *within* a country requires national regulatios and supervision. The liberalisation of capital movements *across* national borders requires coordination and regulation at an international level.

Countries on the European continent have a regional approach to this. They have drawn up a set of laws and rules that govern a common European market, the single market. Norway also participates in this market by virtue of the EEA Agreement. European Monetary Union effectively removes the possibility of speculation between the currencies of the countries involved, thereby increasing the stability of the financial system in Europe.

International rules for economic relations with other countries are important, particularly for small countries. Cooperation within the framework of the WTO and GATT agreement on trade in goods and services are examples of this. The OECD Capital Code, which provides a framework for member countries' laws and regulations on capital movements is another example. Initiatives have been taken by both the International Monetary Fund and the Bank for International Settlements to create a new international regulatory framework and system. The aim of this work is to reduce the risk and effects of serious financial crises.

One solution that will not be effective is the reimposition of direct capital controls, given the vast increase in technological capabilities to evade them. The business sector is already international. Capital controls are disadvantageous to the business sector in the countries that introduce them.

International developments

Turnarounds in the international economy are often abrupt. 1998 was marked by pessimism. The crisis-hit countries in Asia were struggling. Russia was faced with severe economic problems. Last year, only two years later, growth in the world economy reached the highest rate recorded in 15 years.

Global economic developments are marked by the turnaround in the US economy. The US accounts for about 20 per cent of the world economy. The turnaround in the world's largest economy will have an impact, also in Europe. The question is how severe the turnaround will be, and how strong the impact will be on European economies.

The US economy expanded by 5 per cent last year. The upturn in the US has spanned almost 10 years - the longest cyclical upturn ever. The chart shows OECD forecasts and actual developments over the past five years. As we can see, growth has been stronger then expected every year in this period. At the same time, inflation was moderate and unemployment declined.

Many observers attribute the prolonged period of strong growth to the new economy, which features three main aspects:

- The labour market had become more flexible. While earlier experience implied an acceleration in the rate of increase in wages and prices at an unemployment rate of six per cent, unemployment fell to four per cent without triggering higher inflation.
- Productivity growth increased in both the IT sector and in other industries. The forecasts for the annual growth potential of the US economy were revised up substantially to around 4 per cent.
- Equity prices for technology stocks advanced sharply, with more than a sixfold increase in the Nasdaq index from the beginning of 1995 to the peak in March 2000.

Strong productivity growth and low wage growth led to a sharp increase in corporate profitability. Expectations of a continued rise in profits spurred sharp growth in investment. At the same time, advancing equity prices boosted household wealth. Households could reduce their current saving and still increase wealth, allowing them to use a growing share of income for consumption.

But imbalances heightened. The fall in the household saving ratio was based on gains in the stock market, which after a time reflected unrealistic expectations of future earnings. Corporate debt increased sharply and current account deficits grew larger.

In spring last year, equity prices declined. The Nasdaq index showed a particularly strong decline. The index continued to fall through autumn and winter, with the overall decline nearing 60 per cent. The more broad-based stock indices have also shown a decline, albeit a more moderate one.

Growth has been expected to slow this year for some time. In spite of this, the turnaround in the US economy was surprisingly strong and came faster than expected. Consumer and business confidence indicators have shown a marked fall.

The Federal Reserve has sought to counter the downturn. Interest rates were lowered by 1 percentage point in January. The Government has announced substantial tax cuts. This may moderate the downturn, but hardly bring it to a halt. Consolidation in the household and business sector may imply lower consumption and investment for a period. In 2001, we expect the US economy to expand by less than half the rate recorded last year.

Growth in the Japanese economy is also sluggish, but the downturn in Japan has continued for ten years.

At the beginning of the 1990s the financial bubble burst, following a sharp increase in stock and property values in the preceding years. The banking industry faced serious problems, which have still not be solved.

In addition, government debt has increased sharply in recent years, but neither strong growth in public spending nor near-zero interest rate levels has sufficed to boost growth in the Japanese economy.

Growth in Europe was weak in the mid-1990s. The situation has shown a substantial improvement, particularly from 1997. Growth has picked up and unemployment has declined in an environment of moderate price and wage inflation.

The US and Japan account for close to a third of the world economy. When their economies deteriorate, the question is whether the upturn in Europe is sufficiently robust to maintain its momentum.

Historically, there has been a close correlation between developments in the US and Europe. Slow growth in the US economy will also now have an effect on demand for European goods, but the effects via financial markets are likely to be more important. A turnaround in the US could feed through to European stock markets and may also trigger financial unrest.

Thus far developments in the US have not resulted in a corresponding turnaround in Europe. Share prices in Europe have been relatively stable so far this year, and European economies are still showing solid growth.

The effects on the Norwegian economy

There are no signs of unrest among economic agents in Norway. Households and enterprises still expect growth in future income. If oil prices fall, the situation may be different.

The chart shows the probability of various oil prices ahead. The curve is based on prices in the options market for contracts maturing in December. The vertical axis shows that market participants have priced in a 10 per cent probability that oil prices will be below USD 18 per barrel in December 2001 and a 10 per cent probability that oil prices will be higher than USD 35.5 per barrel in December this year. This would suggest considerable uncertainty.

The chart shows that high oil prices and petroleum production are generating large current account and budget surpluses, with an attendant increase in Norway's disposable income. The current account surplus came to about 14 per cent of GDP last year, which is one of the highest surpluses recorded in an OECD country in the post-war period. In addition, government budget surpluses have increased sharply and reached 14 1/2 per cent of GDP.

The Government Petroleum Fund shall serve as a buffer against short-term fluctuations in oil revenues. As large portions of the revenues from oil activities accrue to the state, fluctuations in oil prices and oil revenues will primarily result in changes in allocations to the Petroleum Fund. Since all of the capital in the Petroleum Fund is invested abroad, such changes will in principle not influence the level of activity in the economy. This makes the Norwegian economy more robust to fluctuations in oil prices and thus less dependent on oil, even in the short run.

Nevertheless, the mainland economy is not completely protected from fluctuations in the oil price. A fall in oil prices will influence petroleum investment and may thereby have a direct impact on employment in some industries. Household and business income expectations may also be affected.

A shift in international developments may also have a direct effect on the Norwegian economy via financial markets.

An international turnaround with a decline in equity prices could influence enterprises' possibilities for financing investment. Household wealth may also decrease. Norwegian households' direct ownership in enterprises is still smaller than in many other countries, which suggests that the effect on domestic demand via equity prices will be limited.

Perhaps the most important transmission channel is the foreign exchange market. The experience of recent years shows that international financial market developments can have a short-term impact on the krone exchange rate. Heightened uncertainty and unrest in foreign exchange markets can lead to higher risk premia on small countries' currencies. Developments in 1998 are one example, when the krone came under growing pressure as a result of the sharp fall in oil prices, turbulence in international capital market in the wake of the Russian crisis and imbalances in the Norwegian economy.

Monetary policy

The long-term objective of monetary policy is to provide the Norwegian economy with a nominal anchor - domestic price stability, and thereby the basis for a stable krone. Nominal stability is the best contribution monetary policy can make to economic growth and prosperity. A nominal anchor is also a necessary precondition for stable financial markets and property markets. High inflation and wide swings in the exchange rate impair the function of prices as an information vehicle. This leads to booms followed by busts and an arbitrary redistribution of income and wealth. Inflation therefore poisons the economy. By linking movements in the krone to the euro, we have chosen to follow the same standard for nominal stability in the economy as set by the euro area countries.

Since 1997, inflation has been higher in Norway than in the euro area. The difference partly reflects a period of strong growth in Norway, while the level of activity in Europe has been low. But the relatively high inflation rate in Norway cannot continue as this will undermine the basis for stability in the krone exchange rate and weaken confidence in monetary policy.

Short-term capital inflows and outflows are probably the most important factor determining movements in the krone exchange rate from day to day, from week to week and from one quarter to the next. They are governed by expectations concerning future returns. Changes in expectations concerning the future value of the krone can trigger extensive capital movements.

As a rule, Norges Bank does not intervene in foreign exchange markets with a view to influencing the krone exchange rate. The krone is floating, and the value of the krone fluctuates in periods by the same magnitude as exchange rates in other open economies. Nevertheless, the prevailing stability of the krone is largely a reflection of confidence that inflation in Norway will be kept at a low level.

Our experience is that changes in the Norwegian interest rate level only have a predictable effect on the krone exchange rate when the change in interest rates also contributes to stabilising inflation. However, the relationship between interest rates and price and cost developments is uncertain. The setting of interest rates thus requires the use of professional judgement and discretion. The basis for exercising discretion is subject to limitations, however. Should any doubt arise as to whether the interest rate is oriented towards nominal stability, this would trigger substantial capital movements.

Interaction with income formation

A precondition for a stable krone exchange rate against European currencies is that price and cost inflation in Norway must over time not exceed the corresponding aim for inflation of the European Central Bank (ECB). The ECB orients monetary policy to maintain price stability, which has been defined as inflation of less than 2 per cent.

In recent years, cost inflation in the euro area countries and among trading partners has been relatively low. Growth in labour costs in Norway has been roughly 11 percentage points higher than in the euro area and 10 percentage points higher than among trading partners for the past three years.

A number of other small, open economies have recorded a decline in unemployment and lower growth in labour costs than Norway. In Sweden, unemployment has shown a substantial decrease over the past five years and wage growth is below 4 per cent. Three-year wage agreements are now being concluded, underpinning the basis for low cost inflation. In the Netherlands, unemployment has fallen to a very low level. Wage growth has picked up, but is lower than in Norway. In Denmark, unemployment has come down without an increase in wage growth. In Finland, unemployment has fallen sharply from the high level that took hold in the 1990s, and wage growth has slowed. In the euro area, unemployment has dropped without an increase in wage growth. In Norway, the high growth in labour costs may be a source of rising unemployment.

Interaction with fiscal policy

It is important that the annual budgets are based on a long-term strategy that takes into account possible fluctuations in oil revenues from one year to the next. With large and, to some extent, varying budget revenues, the basis for determining central government expenditure and taxes from one year to the next may easily be impaired. If budget spending is allowed to vary in step with oil prices, the Norwegian economy may experience abrupt shifts and instability. Changes in oil prices may then quickly influence wage and price expectations, the exchange rate and long-term rates. In addition, short-term rates would have to be changed frequently and sharply.

In recent years, central government real underlying spending growth has accelerated somewhat. In 2000 and 2001, spending growth has been higher than 2 per cent, which is higher than normal growth in the mainland economy. At the same time, direct and indirect taxes have increased. Fiscal policy has thus had a virtually neutral effect on domestic demand for two years while wage growth has been substantially higher than in other countries.

A possible interpretation of this development is that it is more demanding to use the government budget to dampen cyclical fluctuations during an upturn than during a downturn. The willingness and ability to pursue a counter-cyclical policy may in itself be cyclical. Another interpretation is that a neutral fiscal stance this year, with a strong increase in government financial wealth, is a balanced approach to using the budget to stabilise the economy while phasing in an increase in financial income in the economy.

Conclusion

The Norwegian economy is fragile and vulnerable. As long as oil prices are high, the Norwegian economy is fairly sheltered. Many central banks are now reducing their key rates. As our economy is affected to a lesser extent, the differential between short rates in Norway and abroad may widen.

Thank you for your attention.