Economic Perspectives

Annual address by Governor Kjell Storvik at the meeting of the Supervisory Council of Norges Bank on Thursday 19 February 1998

Background

Over the past six months we have witnessed the unfolding of a severe economic setback in Asia. Deteriorating confidence has in record time turned growth into stagnation and compelled the authorities to yield to market pressures and see the value of their currencies fall. These countries have been experiencing considerable problems in refinancing both foreign and domestic debt and it has gradually become clear that a number of Asian countries are experiencing a financial crisis.

The growth in international capital flows over the last decade has led to the emergence of a new global economy with intensified international competition, but also more pronounced fluctuations and greater sensitivity to imbalances in the economy. The financial crisis in Asia demonstrates, as have earlier crises in other regions of the world, that even the fastest growing economies are eventually exposed to strong market reactions when macroeconomic imbalances emerge or the financial system in a country fails to function effectively.

Globalisation also requires internationalisation of economic policy instruments. International institutions such as the IMF and the WTO have an increasingly prominent supervisory and regulatory role in international economic co-operation. In our own region of the world, the EU is establishing an economic policy super-structure for national markets through EMU and the establishment of the EU's internal market, which also includes Norway by virtue of the EEA Agreement. It is fair to assume that the tendency towards more closely integrated capital and goods markets will continue, perhaps accompanied by a growing awareness of the international dimension in formulating economic policy. In other words, it is also fair to assume that the challenges Norway has faced as a result of the integration of our economy into the global economy will reach new heights in the years ahead.

Some of these challenges have been tangible for some time. This applies to the limitations imposed on the conduct of monetary policy, the growing need for financial market supervision, and the constraints on the regulatory framework for business and industry, such as the tax system. Other challenges have not yet received the same degree of attention. Important here would be the effects on the structure of business and industry in our country, which again would have

implications for the government's structural policy. Furthermore, I would argue that there is still room for deepening our understanding of the relationship between different policy areas - between a sound macroeconomic policy on the one hand and how structural policy can best be oriented to promote economic policy objectives, on the other.

In the following I will attempt to shed light on some of these relationships and the attendant consequences for the formulation of economic policy. I will not assert that there is an absolute approach to addressing these challenges, but with the leeway afforded by our oil wealth I would maintain that there is a pronounced risk of our failing to take the challenges seriously. It is my view that there is a need for a more in-depth and fundamental debate concerning the options at hand. I hope, in all modesty, that my address will contribute to fostering such a debate.

From protectionism to integration...

During the period of postwar reconstruction in Europe, it was generally recognised that it was essential to avoid the "beggar-thy-neighbour policy", which was characteristic of protectionism and nationalism in the 1930s. The regulation of the goods market which was necessary in the wake of the Second World War was gradually relaxed, paving the way for growing international trade. This came hand in hand with the establishment of a number of organisations, such as GATT, the OECD, and the IMF, which were to elaborate international regulatory and monitoring systems.

The steady growth in international trade has had beneficial effects, not least for small countries such as Norway, providing us with the opportunity to specialise our economy and develop new sectors where Norway had particular advantages or expertise. Thereby, resources were also shifted from less profitable industries to the production of new goods and services in growing demand.

After trade barriers had essentially been removed, the drive to scale back restrictions on international capital movements began. This was consistent with and the consequence of the trend towards a more closely integrated world economy in the postwar era. The growth in international trade required payment and settlement in international currencies. It gradually proved difficult to distinguish between such current account payments and pure capital transactions, and we saw the emergence of large international markets also for capital and a liberalisation of cross-border capital movements. The deregulation of capital markets can thus be regarded as the last building block to date in the edifice of international agreements and economic integration erected after the Second World War.

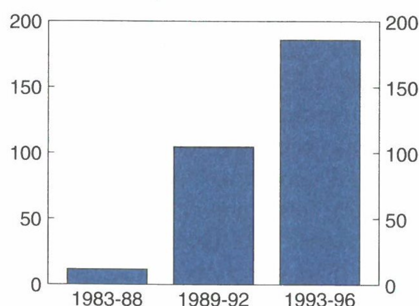
At the beginning of the 1990s most western countries experienced fairly substantial balance-of-payment and bud-

get deficits, high and rising unemployment, and markedly higher inflation than earlier. The large imbalances required a more flexible financial system with a view to facilitating cross-border and cross-sectoral capital flows. This in turn required substantial reforms both in exchange rates and interest rates, and in this context it became increasingly clear that an extensive direct regulation of financial and capital markets was undesirable.

In many countries such regulation, in conjunction with high inflation and inefficient tax systems, gradually led to a very low required rate of return on investment, with wide variations in the required rate of return for different types of investment. The result, not least for Norway, was that the high investment rates eventually contributed little to increasing economic prosperity, while the share of directly unprofitable investments was rising.

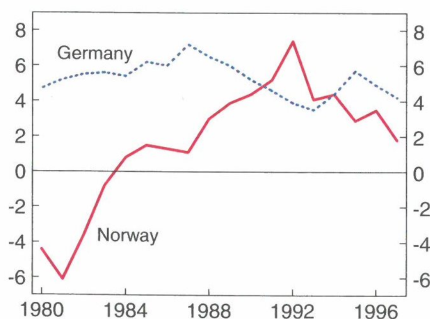
Moreover, market regulations gradually lost their effectiveness as a result of technological developments. It became clear that it was neither possible nor desirable to maintain capital restrictions.

Chart 1 *Private net capital inflows to non-OECD countries. Developing countries, economies in transition and newly industrialised countries. In billions of USD. Annual average*



Source: IMF

Chart 2 *Real after-tax interest rate. Borrower with average marginal tax. Per cent. 1980 - 1997*



The real after-tax interest rate in Norway was negative in the early 1980s. Developments in the second half of the 1980s resulted in a normalisation of borrowing costs in the Norwegian credit market compared with international borrowing costs.

Source: Deutsche Bundesbank and Norges Bank

... and global required rate of return

As restrictions were gradually dismantled, investment projects had to be compared with competing projects in other countries, in principle throughout the world. Some of the best business opportunities turned out to be in countries which were less developed than rich countries, and where the potential for profitable investment was highest. Not least did this, at least until recently, benefit Asian countries. As capital flows accelerated, the highly profitable investment opportunities in Asia probably resulted in, at least to some extent, higher required returns also on investment in western countries.

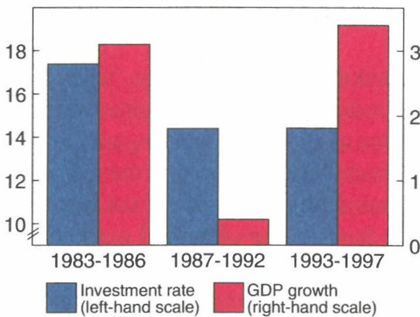
The result was that investment in our part of the world shrunk while investment in newly industrialised countries surged. A larger share of savings in the western world is now invested in other countries and is reflected in the sharp growth in capital outflows from the OECD area.

The low return on capital in Norway in the 1970s and the first half of the 1980s was also an indication that financial markets were functioning poorly, and that the capital market in Norway was isolated from the rest of the world. Interest rates were determined politically and the tax system was designed so that real interest rates after tax were either very low or negative. Both elements meant that the capital market did not provide "correct" information - in the form of interest rate signals - to lenders and borrowers alike. The result was partly that the overall level of investment became unnecessarily high, alongside an inappropriate composition of investment as the credit rationing system did not allow resources to flow to the most profitable investments.

It gradually became clear that capital controls could not be maintained in Norway either. The property market, credit market and foreign exchange market were deregulated in the 1980s. The growth in international capital movements and more efficient markets - which were quick to exploit the advantages of arbitrage - revealed the distortions in the tax system with even greater consequences than earlier, which was partly reflected in the credit boom in the 1980s. The tax reform of 1992 eliminated many of the former distortions in the tax treatment of various forms of saving and investment. From this perspective, the tax reform was a natural consequence of the previous changes which had taken place in capital markets.

Since the deregulation of capital markets and the tax reform of 1992, the required rate of return in Norway has been more closely in line with the international one, and the credit market is functioning more efficiently in terms of channelling resources to investment projects which are more profitable for society as a whole. I would say that it is now generally recognised that these are preconditions for channelling investments to competitive projects and maintaining a profitable business sector.

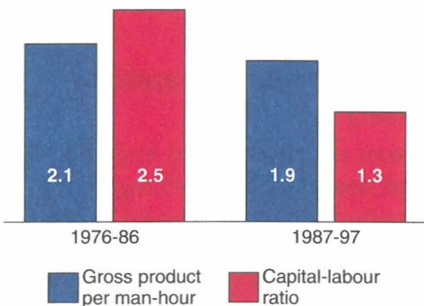
Chart 3 *Investment rate[1] and business sector GDP growth, mainland Norway. Annual average. Per cent*



[1] Gross business fixed investment as a share of gross product.

Source: Statistics Norway

Chart 4 *Productivity and capital formation. Business sector mainland Norway. Average annual growth*



Productivity growth in the business sector of mainland Norway has been approximately the same over the last two business cycles. In the early 1980s, productivity increased primarily as a result of robust growth in capital stock. Since 1986, investment growth has been much lower, while capital stock has become more productive.

Source: Statistics Norway and Norges Bank

Have reforms yielded productivity gains?

Profitability gains in the business sector would be a meagre consolation if these changes did not also generate added growth. At first glance, it may seem that the most important consequence has been a sharp decline in investment.

However, a comparison of investment and output trends shows that production growth is somewhat higher at this stage of the present cyclical upturn than during the expansion in the 1980s, although investment rates are now lower. It would appear, therefore, that investments have become considerably more productive than in the 1980s.

Some people would promptly object, arguing that the high GDP growth rates recorded so far during this cyclical upturn are primarily ascribable to the sharp growth in employment. Adjusting for the effects of cyclical swings in the labour market, we should instead compare trends in capital formation and productivity over a longer period.

Growth in capital stock is a common explanation for growth. Thus, we would expect the fall in the investment rate in the 1990s to lead to a decline in productivity growth. Productivity growth per man-hour over the last two business cycles, the eight-year period between 1978 and 1986 and the 11 years between 1986 and 1997, was nonetheless almost identical. However, in the period from 1978 to 1986 productivity primarily rose as a result of a surge in investment and sharp growth in the amount of capital behind each man-hour. The increase in the capital-labour ratio was actually higher than the rise in labour productivity in this period.

Over the last 11 years this trend has been reversed. It may be said that we have experienced an "unexplained" productivity growth - a growth in productivity which cannot be explained by a higher level of capital formation. Furthermore, it should be noted that the capital-labour ratio is now rising at a much slower pace, down from 2½ per cent in the beginning of the 1980s to 1¼ per cent over the last 10 years. In spite of this, productivity growth has been maintained.

There may be several explanations behind this development. It may in part be that we are still living off the overcapacity from the previous cyclical upturn. Furthermore, we have seen the introduction of new technology, and it is possible that new technology has provided a substantial boost to productivity. It may also be that today's workforce is more productive, partly as a result of a more highly educated workforce.

On the other hand, it is striking that such a large "unexplained" improvement in productivity has taken place during a period of extensive reforms as far as the Norwegian capital market is concerned, with both deregulation and the tax reform of 1992. One of the stated objectives of the tax reform was notably to enhance the functioning of capital markets and to promote investments which generate a higher rate of social return. Although there may be many reasons behind the increase in the social return on capital - as measured in the chart - it is difficult to escape the conclusion that these reforms may have made a highly positive contribution.

In other words, it would seem reasonable to conclude that capital market reforms, in conjunction with the tax reform of 1992, have contributed to improving the return on the capital which we as a nation invest, which may also over time lead to higher growth than earlier.

New environment places greater demands on stability and adaptability

However, there are also some negative aspects to participating in international capital markets. Some will regard it as a drawback that we, as a nation, are more exposed to international developments, and that the forces of the international economy prompt changes of which we may not immediately see the benefit. Others may view this as an advantage, perhaps even a sort of "guarantee" against having the political authorities implement or maintain measures and regulations that are detrimental to the economy. Yet others may feel that the increased return on capital has negative distributional effects which must be remedied. Added to this is the fact that the market players do not always appear to act entirely rationally - at any rate, not in the way the authorities would like them to act.

The essential point for me is that in the long run Norway neither can nor should opt out of the global process of inte-

gration and the international agreements that regulate the flow of goods and capital in the world economy, or shun the influence of the international capital markets. In our domestic debate there has been a tendency to focus on the disadvantages of these markets, and we have been inclined to forget the obvious advantages for Norway of participating in international markets and achieving an acceptable return on the nation's saving. This applies not least to the Government Petroleum Fund, which is all being invested abroad.

We must thus take as given - and this is no revolutionary insight - the framework conditions for our economic policy that are determined by the way the world society has chosen, explicitly or implicitly, to organise economic activity. The fact that capital flows freely across national borders is one that we may or may not like - but it remains a fact, and there is little we can do about it. Norway is a small country. The most fruitful and realistic strategy is therefore to focus on how best we can adapt to the prevailing framework conditions.

We can also, of course, work in international fora to attempt to change those aspects of the system that we do not agree with. We cannot always expect to find acceptance for our views, but working outside the system is not a viable proposition either - at least not for small nations.

As I see it, the consequences of the new environment for Norway's economic policy, and for the formulation of framework conditions for the business sector, can be summed up in two key words: stability and adaptability.

The Norwegian authorities must provide the private sector with framework conditions that enable it to adjust to globalisation and join in the international competition for capital. This means that when these framework conditions are formulated, emphasis must be placed on *stability and credibility*. Moreover, it implies certain limitations to the burden that can be imposed on the private sector in terms of taxes and administrative costs. Through economic policy, the authorities can also contribute to a stable economic development, thereby avoiding severe macroeconomic imbalances and new crises in the financial sector.

The need for *adaptability* applies to many areas of economic policy. First, because of the volatility of the markets and the world economy, we must be prepared for sudden, unexpected changes in our environment - changes that may necessitate major or minor shifts in economic policy. A policy that is highly effective in one period may not necessarily be an appropriate remedy for the next one. Second, the arm of economic policy with the greatest influence on the operating environment for the private sector - structural policy - must be geared so that the private sector can also rapidly adapt and address new challenges.

Stabilisation policy under pressure

Changes in the world economy have had a major impact on the conduct of monetary and exchange rate policy. From a system with politically determined exchange rates, small capital movements and administered interest rates, we have witnessed a gradual transition to a situation with large movements of capital, more unstable foreign exchange markets and interest rates strongly influenced by international interest rates and market conditions.

In Norway we have a system whereby Norges Bank seeks to maintain a stable exchange rate, which implies that interest rates must be adjusted to ensure balance in the foreign exchange market. This means - broadly speaking - that interest rates in Norway are largely determined in Frankfurt, based on the objectives set by the German monetary policy authorities.

This audience is probably aware that our political authorities and Norges Bank have somewhat different views on the question of how monetary policy should be oriented in the present situation. Norges Bank has not changed its view since last autumn, when the Bank presented its assessment in a submission to the Ministry of Finance.

At the same time, I would like to underline that Norges Bank takes due note of the view of the authorities and loyally abides by the monetary policy guidelines laid down by the political authorities. Therefore I do not intend to make this a topic for discussion here this evening. However, I do find it necessary to bring a brief reminder of the consequences of the monetary policy chosen.

When the authorities choose to use interest rates to stabilise the exchange rate, fiscal policy must bear the responsibility for stabilising the economy. With a system based on a stable exchange rate, it is therefore crucial that the authorities really do succeed in implementing their fiscal policy in such a way that large, undesired cyclical movements do not occur.

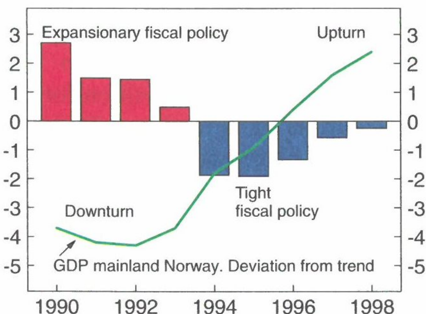
At the same time, it may be a demanding task to reconcile the concerns of stabilisation policy with all the other objectives inherent in fiscal policy.

In my view, this problem has become more evident over the past year than earlier in this economic upswing. In the end, fiscal policy in the budgets for 1997 and 1998 has been virtually neutral in spite of the fact that the current upswing is about to reach its peak. Moreover, monetary policy is having an expansionary effect due to the need to keep interest rates in line with the low rates on the continent.

In other words, we cannot escape the conclusion that *neither* monetary policy nor fiscal policy currently seems to be contributing to stabilising the Norwegian economy.

In this situation, the political authorities appear to be placing much of the responsibility for economic stability on the social partners and their willingness to show wage re-

Chart 5 *Fiscal policy and the business cycle. Per cent. 1990 - 1998*



Cyclical movements are illustrated by the output gap, which shows the difference between actual and trend GDP for mainland Norway. A positive output gap means that production capacity utilisation is higher than the trend GDP level would suggest. The impact of fiscal policy (expansionary/tight) is measured by the change in the non-oil, cyclically adjusted budget surplus net of interest payments. Both measures are expressed as percentage of mainland GDP.

Source: Statistics Norway, Ministry of Finance and Norges Bank

straint in income settlements. In my view - and with due respect for the partners involved - this is a responsibility beyond the powers and means actually available to the social partners. Consequently, there are definite limits to what we can reasonably expect to achieve through the use of incomes policy.

All in all, the odds seem to be against our succeeding in influencing cyclical developments so as to avoid a turnaround in a few years' time. We must at least be prepared for the economy to gather even greater momentum and then to slow down because of supply constraints - primarily in the labour market. The projections prepared by Norges Bank suggest that this downturn may be pronounced. As I mentioned initially, we cannot exclude the possibility that capital markets will react to such a situation, thus amplifying the downturn - as we have seen these markets do in the past, to the situation both in Norway and in other European countries in the early 1990s, and most recently in Asia.

If economic policy cannot deliver the stability we all really want, the following critical question arises: Is the Norwegian economy - our businesses and households - better equipped to cope with such a cyclical downturn today than it was in the late 1980s?

Once again, in my view this is a matter of stability and adaptability. The basic premises for emerging unscathed from such a downturn will be that underlying structures are sufficiently stable. The next requirement is that the economy does not falter under the weight of the downturn - and that the business sector is sufficiently flexible to be able to adapt rapidly to changes in framework conditions.

These are complex issues, to put it mildly. Nor is there any simple answer to the question of what is required to provide the economy with the desired features. To make the task a little easier - and without claiming to have given the subject exhaustive treatment - I will concentrate in the following on two aspects that I believe may become crucial:

- First, I believe that the stability of the economy will largely depend on adequate financial strength in the business sector in general, and the financial industry in particular. Without such strength we could easily experience a domino effect of the type recently seen in Asia - and such as we experienced ourselves in the early 1990s - in which bankruptcies of individual firms and sectors quickly spilled over into other parts of the economy. In the light of developments in Asia, I also believe that the strength of the financial sector in particular will be decisive for how strongly the international markets react, and hence also for how strong the turnaround will be.
- Second, I believe that the adaptability of the business sector will largely depend on our continued ability to

ensure a reasonably efficient allocation of capital. Investments must be sound and have such high profitability that they are viable in bad times as well as good, also because it is these new investments, the new capital, which have to provide impetus for growth at the next stage. In the light of the changes I focused on earlier - with strong competition for international capital and higher required rates of return - I would also argue that the actual organisation of the capital market may be decisive. In particular, I feel that it is necessary to focus on the significance of the ownership situation in the business sector and financial industry, including the role of the state as owner.

Financial strength

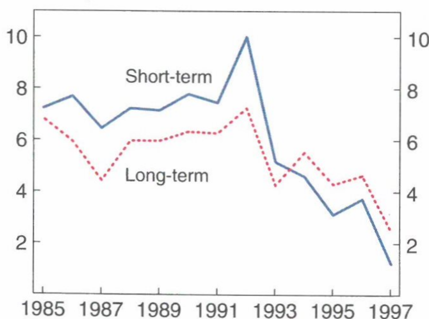
The financial crisis in Asia and our own banking crisis illustrate the close connection between the stability of the financial sector, developments in foreign exchange markets, and economic policy and domestic developments. Both our own experience and those of others over the past ten years show that a financial sector with sufficient strength and soundness is necessary if we are to make it through the next turnaround and currency unrest without major difficulties.

A fundamental problem for the authorities with respect to the regulation of the financial system is what mechanisms we actually have to ensure that the financial sector's behaviour does not lead us as a society into assuming excessive risks.

There are a number of reasons why decisions made by an institution, which are reasonable in isolation, may contribute to weakening the stability of the financial system as a whole. One possible reason is that an individual bank may be concerned only with the risk it is exposed to itself, and not with the risk to which it indirectly exposes others. This *systemic risk* is partly related to the interaction with international financial markets and the Norwegian banks' interdependence in the Norwegian credit market. For example, a Norwegian bank's creditworthiness abroad will depend not only on the bank's own position, but also on how sound the Norwegian system as a whole is perceived as being. We have experienced in the past that unrest in parts of the financial market makes foreign financing more difficult or even impossible to procure, even for institutions that initially did not have problems with their liquidity or financial strength. Thus the manner in which individual banks are run can constitute a risk to the financial system as a whole. I believe this has also been an important factor in a number of crises abroad, most recently in Asia.

Like the great majority of other western countries, Norway has a broad set of regulations to deal with these and other risks that could conceivably arise in the financial in-

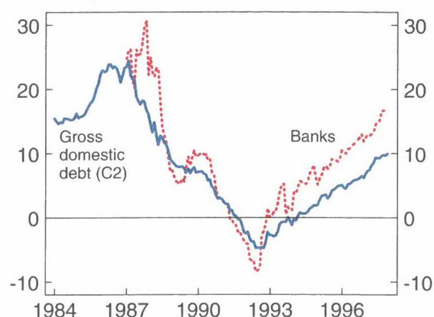
Chart 6 *Real interest rates in Norway[1]. Per cent. 1985 - 1997*



[1] Three-month euro-krone and five-year government bond yield rate adjusted for CPI growth.

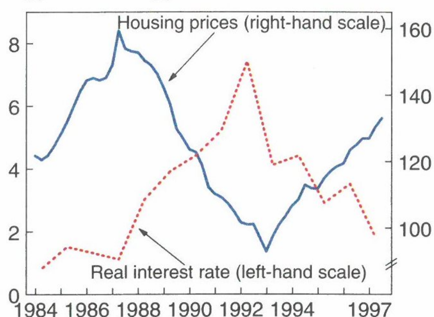
Source: Statistics Norway

Chart 7 *Lending growth. Per cent. January 1984 - December 1997*



Source: Norges Bank

Chart 8 *Real after-tax interest rate and real price of resale homes. Percentage and index 1992 = 100. 1Q 1984 – 3Q 1997*



In the past 10-year period, real interest rates and resale home prices have shown a clear negative covariance. Since 1993 housing prices have risen by over 40 per cent, while real after-tax interest has fallen from over 7 per cent at end-1992 to 2 per cent in 1997.

Source: Statistics Norway, ECON and Norges Bank

dustry. An example of such a regulation is the capital adequacy requirements, which are intended to safeguard the financial strength of the sector, and thereby counteract systemic risk.

At the same time, I would like to stress that even with the current rules and supervisory framework applying to the financial sector, and even though both the sector and its customers are undoubtedly more solvent and far more concerned with risk management and control today than they were ten years ago, we still cannot exclude the possibility that the financial system may come under pressure again if the macroeconomic situation deteriorates.

The current situation in the money and foreign exchange markets is such that Norwegian monetary policy must be expansionary to maintain a stable krone exchange rate. The monetary policy of most other European countries is also relatively expansionary, but the cyclical situation there is quite different. In consequence, real interest rates in Norway - measured as market rates adjusted for inflation - are now somewhat below the level recorded in the mid-1980s.

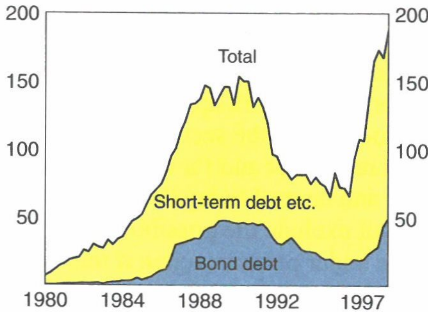
If we disregard risk premiums, investments can currently be considered as profitable with a return as low as 2-3 per cent. In the light of the fluctuations in interest rates witnessed so far, and which may recur, it may be relevant to consider the possible effects of such a return on marginal investments on the financial position of the business sector, at least if the volume of such investments should become substantial.

With such low interest rates the current brisk growth in credit demand was to be expected. We must assume that any future fluctuations in interest rates could cause bank losses to rise, and that parts of the business sector might again experience debt payment difficulties.

Nor can we exclude the possibility that the lending portfolios of a number of banks have become more exposed to risk. At the same time, the expansion of the past two years has caused a slight decline in banks' capital ratios. This is somewhat paradoxical as we would normally expect institutions to improve their financial position in periods of expansion.

Low interest rates and a greater risk of losses must also be seen in conjunction with trends in the property market. As a result of growing demand and ample availability of credit on reasonable terms, house prices have shown a real rise of over 40 per cent since the low of 1993, and the real price of houses is now approaching the peaks of the 1980s. The price of commercial property has also shown a sharp rise. Judging by the substantial fluctuations we have seen previously, there is reason to assume that a downturn in the economy will in turn lead to a fall in property values. Some of this price risk will affect banks, as a share of their loans is secured in real property.

Chart 9 *Banks' foreign funding. In billions of NOK. 1Q 1980 - 4Q 1997*



Source: Norges Bank

One noteworthy feature is that a substantial part of the growth in bank lending is now funded abroad. Total foreign funding amounted to almost NOK 190 billion at the end of November last year. This means that this type of financing has increased by some NOK 120 billion over the past two years. The sharp growth in foreign financing is partly due to the upgrading of banks' creditworthiness by foreign rating agencies, enabling them to obtain cheaper financing in international bond markets. But as we see from the chart, this bond financing accounts for a small share of the growth in overall foreign debt. In other words, a substantial part of foreign financing - about three quarters - is short-term.

I should add that banks normally hedge this type of borrowing against currency risk, by means of forward transactions for example, so that their foreign currency exposure does not increase. Moreover, the Norwegian financial sector easily complies with the international and national requirements regarding capital adequacy, and the Norwegian banking industry is recording substantial profits. However, I would argue that a number of emerging features, if left unremedied, may be grounds for concern in the not too distant future.

The risk associated with a large volume of short-term foreign funding is that the financial sector as a whole - *as a system, and over time* - may be exposed to a substantial liquidity risk. If the supply of foreign credit should suddenly dry up or be reversed - for example in the event of an economic downturn, or loss of confidence in our currency - this type of financing could give rise to severe payment problems, as we have seen in Asia.

This scenario is a familiar one, since we experienced precisely this type of problem during the banking crisis in the early 1990s. If the banks were to experience limitations in the supply of foreign financing again, they would be confronted with considerable challenges. In response to the previous crisis, Norges Bank had to channel substantial funding to the banking system. It would be a mistake to assume that this would happen in precisely the same manner again if problems like this were to recur.

In isolation, recently published bank results show a sound return on equity. However, this is largely attributable to very low losses. Earnings are not sufficient to allow banks to maintain their capital ratio, at least if lending continues to expand at the current pace. Gradually, as we see a normalisation of the loss situation, and for some banks their tax position as well, earnings will tend to decline.

Financial strength and structural policy are related

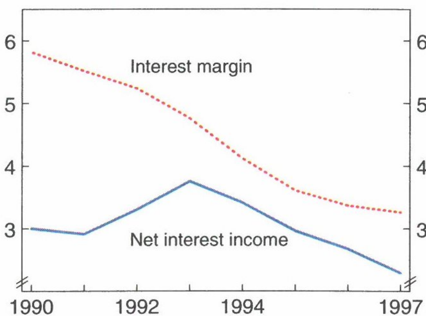
An issue which comes to mind is whether the authorities should do something - and if so, what - to improve banks' long-term earning capacity and financial strength.

One alternative could be to impose stricter capital adequacy requirements for financial institutions. We should, however, bear in mind that Norwegian institutions are to an increasing extent in competition with foreign institutions, and a tightening of requirements in Norway alone could lead to a deterioration in earnings over time. Stricter capital adequacy requirements may therefore be a double-edged sword. On the one hand, such requirements would inevitably strengthen existing Norwegian banks' financial strength over time. On the other hand, the same requirements would not provide a level playing field and could perhaps result in higher market shares for foreign institutions which are not subject to such strict requirements. Reduced competitiveness for Norwegian institutions may result in a fall in earnings, and thereby diminish the ability to improve financial strength through internally generated funds.

The Banking, Insurance and Securities Commission recently published a report which includes an evaluation of tighter core capital requirements for financial institutions. The Commission concluded that there is not sufficient reason at present to recommend such strong measures.

In my opinion, the best way to ensure Norwegian banks' financial strength in the period ahead is to establish an operating environment where Norwegian banks can compete with foreign institutions on a level playing field. The application of the authorities' structural policy in the financial sector has a considerable influence on competitive conditions in the long term, and therefore also on the earning potential and financial strength of the industry. In this connection, I am of the view that the authorities must also consider the possible consequences of state ownership.

Chart 10 *Banks' interest margin and net interest income[1]. Percentage points and per cent of ATA 1990 - 1997*



1 'Banks' net interest income' is measured as net interest income as a share of average total assets.

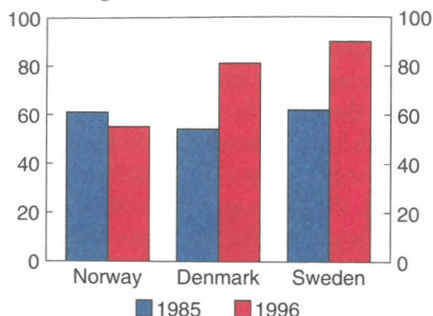
Source: Norges Bank

The Norwegian banking market is now open to foreign institutions which, combined with the internationalisation of business and industry, has resulted in sharper foreign competition and an increase in the required rate of return on bonds and equities. Increased international competition also generates benefits as a result of improved cross-border allocations of capital, and thereby generally also more productive investment. As I indicated earlier, these are gains from which Norway can also derive substantial benefits. However, it also implies considerable challenges for the Norwegian financial sector.

One of these challenges is that competition appears to contribute to a reduction in earning power. The interest margin - the most important source of income for banks - has declined substantially over the past ten years. There has also been a clear downward trend in banks' net interest income, measured as a share of total assets. Both these elements indicate growing competition for deposits and loans, There are no signs that the intensity of this competition will slacken in the next few years - rather to the contrary.

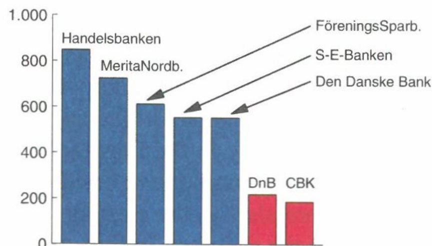
One possible explanation is that *economies of scale* in the

Chart 11 *Concentration in the banking sector. Market shares (lending). Five largest banks*



Source: Norges Bank and Finlands Bank

Chart 12 *Total assets in selected Nordic banking groups. In billions of NOK. At 30 June 1997*



Source: The groups at 30.6.97

sector may have increased. Closer integration and new information technology allow, more than ever, for the mass production of financial services, and modern communication systems make it possible to distribute these services far more cheaply. Development costs for such systems can be substantial, which may in turn give rise to economies of scale.

Different measures for market concentration indicate that there is relatively low concentration in the Norwegian banking market, and considerably lower than in other Nordic countries. Whereas concentration in the Norwegian market has remained more or less unchanged over the last ten years, concentration in the other Nordic markets has increased considerably, in part due to the restructuring of the sector following the banking crisis of the early 1990s.

The Norwegian banking sector is still characterised by many, primarily small institutions. The two largest Norwegian banks are small compared with other Nordic financial institutions.

There are clear indications that Norwegian banks could handle a larger customer base than today without any increase in the use of resources, and that technological and market developments may amplify this trend in the years to come. In other industries, surplus capacity as a result of a deterioration in profitability would lead to adjustments as the least profitable businesses exit the market or through the closure of unprofitable activities. Thus, capacity would be adjusted over time to market conditions in the sector as a whole. Due to the ownership structure and regulatory framework, such downsizing mechanisms do not have the same function in the banking sector, which exposes the industry to persistent surplus capacity and reduced profitability. The trend in profitability and liquidity risk also gives some grounds for concern regarding the long-term stability of the financial system in Norway.

The challenge facing the authorities is to achieve a situation where competition is sufficiently strong to ensure an efficient market, while ensuring at the same time that capacity is adjusted and stability in the system is safeguarded. In my opinion, a banking market which is characterised by increasingly sharp competition and relatively low concentration indicates that there is scope for greater concentration without competition becoming weaker than it is today.

The number of banks - and the location of these banks' head offices - has not been a key issue in the debate on the banking structure in Norway. Equal emphasis has been placed on internationalisation and technological advances, which point to substantial structural changes and a sharp increase in competition. The debate in our neighbouring countries and a number of other countries where the banking structure is now undergoing considerable changes, is based on completely different underlying assumptions. The

largest Nordic banks have claimed the Nordic countries as their home market and are now established in Norway.

I would also like to point out that in a year's time it is highly likely that an extended financial system will be established on the continent, where financial institutions will, in principle, compete in a large European market with a common currency and a joint European payment system. It is also likely that large, deep markets will develop for securities denominated in euro. There is, to put it mildly, no reason to believe that this development will reduce economies of scale or the trend towards higher concentration in the European financial sector. This will also affect the Norwegian financial industry.

In the light of this, I would venture to say that the Norwegian debate on the structure of the financial sector appears to be somewhat inward-looking and short-sighted.

In the introduction, I focused on the advantages that we, as a nation, have gained from improved efficiency in the capital markets, and there are many indications that this has made investment in the 1990s more productive than in the 1980s. Against this background, I would emphasise that acquisitions and mergers in the banking industry are, in all probability, necessary and desirable - prompted by deep structural changes in both the industry itself and international capital markets.

If the authorities' rules and attitude towards mergers and acquisitions are restrictive, it may not be possible to implement the necessary structural changes. This could lead to structural rigidity and serve to perpetuate surplus capacity in the sector, which in the long term could also undermine stability in the financial system. It is my view that the authorities should therefore show caution with regard to preventing structural changes and other adjustments which the sector itself deems appropriate.

Structural policy and state ownership

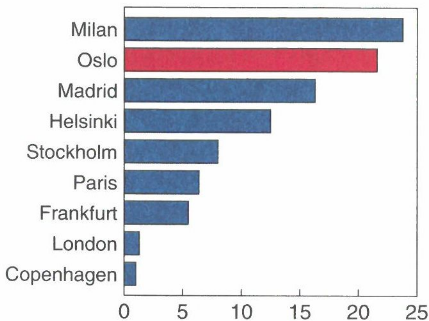
The potential for acquisitions and disinvestment is an important instrument for business and industry as a whole in order to ensure profitable operations and to adjust to changes in underlying structural conditions. There is a risk that a large state owner may in fact impede necessary changes by shielding the existing structure of the banking industry from acquisitions. This does not necessarily need to be the result of an active policy. As long as the state wishes to remain a dominant owner in a bank, this position in itself may deter potential buyers, particularly when state ownership is viewed in the light of other ownership restrictions.

It seems to me that the authorities' *primary* task must be to ensure that the general public has access to the cheapest and most reliable services possible, by means of real, open

competition, and that institutions are sufficiently sound to withstand cyclical fluctuations in the future. These tasks can be accomplished by means of the authorities' traditional functions, as legislator and licensing and supervisory authority.

On the other hand, I believe that some serious objections may be raised if the role as owner is used to favour particular considerations in the implementation of the authorities' structural policy. On the basis of developments seen in the financial sector and the increased risk of financial instability as a result of these developments, it would be particularly inappropriate, in my opinion, if the government's ownership strategy were to place too much emphasis on preserving the sector's existing structure. A professional owner also keeps the alternative to sell as an option.

Chart 13 *Public ownership. Percentage of total market value on stock exchanges. 1992-94*



Source: Oslo Stock Exchange

As we all know, the central government's ownership interests in Norwegian business and industry are not only confined to the financial sector. The National Insurance Fund has substantial ownership interests in many of the companies listed on the Oslo Stock Exchange, and the state maintains shares in some large, listed companies. In addition, there are both large and small wholly-owned public enterprises which are not listed, such as Statoil, Telenor and the state banks.

I do not think that I am exaggerating when I say that state ownership in business and industry is considerably lower in many other western countries. While sales of bank shares and a number of issues in privately-owned companies have resulted in a reduction in state ownership in recent years, following the period shown in this chart, the state continues to be a more dominant owner on the Oslo Stock Exchange than in the mid-1980s.

It is difficult to judge the market value of state-owned institutions which are not listed, but it would not surprise me if total state ownership, even at a fairly conservative estimate, amounted to as much as a quarter of the total value of Norwegian business and industry. Through its budgets, the state also has direct decision-making authority over the share of total investment - around 20 per cent - made by the public sector. All in all, the state therefore influences, either directly or through its ownership interests - and this is a very rough estimate - around 40 per cent of the capital which is allocated annually in this country.

There are several sides to this, all of which are not necessarily negative. When I mention it, it is in connection with a topic that has been predominant this evening, namely the possible consequences that state ownership may have for business and industry's *adaptability.*

In the light of the substantial changes that have taken place in capital markets, the competitive climate prevailing in international capital markets and the considerable challenges we face in the long-term formulation of fiscal policy,

I would like to raise the question of whether the strategy underlying state ownership and direct involvement in business and industry is sufficiently forward-looking.

It is perfectly legitimate for the state to acquire ownership stakes in individual enterprises, when special circumstances so warrant. My concern is not that the state has such stakes. However, I would like to focus on the consequences of the large *overall* state ownership for efficiency in the Norwegian capital market, and thereby for adaptability in the long term. In other words, it as a matter of balance rather than an "either/or". But I must add that sometimes the special circumstances that warrant substantial state ownership are not always obvious.

One question that must be asked when the state becomes heavily involved on the ownership side in business and industry is how this ownership *affects the distribution of capital between different industries and enterprises over time.* When the state or public sector enters the market as an owner - and thereby assumes responsibility for choosing between different investment projects through capital management - the risk is twofold: on the one hand, an investor may become too short-sighted - focusing on short-term returns rather than the long-term need for financial strength and supply of capital to new profitable projects. On the other hand, the investor also risks becoming too far-sighted - failing to require sufficient returns and thereby also failing to provide necessary signals regarding restructuring and efficiency.

Bearing this in mind, I believe there is reason to ask the following questions: have we established sufficiently robust decision-making mechanisms and institutions to be reasonably convinced that state ownership does not result in a distortion in investment at the expense of the most profitable projects? Or does the state in one way or another shift the balance in the capital market through its ownership interests? And if that is the case, are we sufficiently sure that the share of capital investment that can only be supplied through decisions made by the authorities always promotes the need for long-term profitability, thereby ensuring that the business sector has the ability necessary to adapt when circumstances change?

Internationally, there is now broad and growing recognition that a system involving an extensive allocation of capital through government budgets, partly through state ownership, may have negative effects on the economy's adaptability and growth potential. For this reason, a shift to more market-based solutions has been taking place throughout the world.

I believe that also our own experience of a politically-determined capital supply, as was the case when the markets were regulated and considerable investments were made in state manufacturing industry in the 1960s and 1970s, does

not suggest that such experiments should be repeated. Rather, the politicians' aspirations for control and management should be coupled with a good dose of humility with regard to the authorities' ability to make the appropriate choices in the long run.

Conclusion

If I am to draw one lesson from what I believe we have learned from the globalisation of the world economy in the past decade, it would be as follows: in a world characterised by substantial and sudden capital movements, the competition for and more efficient use of capital, economic policy must to a greater extent be formulated with a view to the realities of tomorrow, rather than those prevailing today. In a changing world, we must learn to live with shocks and turbulence in the economic system. This implies that we must formulate economic policy with the aim of strengthening the stability of the economy, but at the same time be prepared for shocks and changes. Therefore, a part of economic policy should also focus on improving the adaptability of the Norwegian economy, to ensure that the business sector is sufficiently robust to recover from any shocks and crises that may arise.

I started this address by saying that I hoped to contribute to a debate on how such a policy should be formulated. I have highlighted some elements which I believe to be critical factors - the strength of the financial system and structural policy. In addition, there may be grounds for looking more closely at the role of state ownership. Our capacity - and perhaps will - to organise ourselves in such a way that we continue to have a reasonably smooth-functioning capital market may be decisive in terms of how we adapt to inevitable structural changes in the future.

It may well be that some of my comments will be perceived as controversial. If that is the case, then I will have succeeded in my attempt to stimulate the debate.