Economic Perspectives

Summary of address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 14 February 1991

In his annual address, delivered in Oslo on 14 February, the Governor of Norway's Central Bank, Hermod Skånland, emphasised the important role that increasing international integration will play in the years ahead, particularly in Europe. This integration would affect Norway even if the country did not itself participate in the negotiations on further integration. He emphasised that for Norway, increased integration means new challenges, but also new opportunities.

In his survey of the Norwegian economy, Mr. Skånland said that large parts of Norwegian business and industry will face stiffer competition. Moreover, there will be less scope for departure from the economic policy of other countries. In recent years Norway has improved its capacity for meeting these challenges by reducing price inflation to a level below that of her trading partners. Furthermore, the free wage round in 1990, following two years of wage legislation, did not result in a wage explosion. Last year the external economy showed a surplus corresponding to 4 per cent of GDP.

However, the improvement in the external economy last year was due to higher oil prices and reduced ship imports. The deficit of the mainland economy widened somewhat, after substantial improvement in the three preceding years. For some years now the mainland Norwegian economy has to a large extent been assisted by rapid growth abroad, a trend which may easily be interrupted for some time. Major trading partners, like Sweden and the United Kingdom, will need to re-establish a proper balance in their economies. Oil production is expected to rise to a new peak in 1991, and a current account surplus is expected in 1991, even at the current oil price of about USD 20.

It now appears that a high level of oil production can be maintained for a longer period than was previously thought possible, and an increasing share of the oil revenues will accrue to the state. However, this does not make room for a more expansionary fiscal policy. Even at the estimated peak level, the state's oil revenues will barely cover the deficit before oil revenues, excluding repayments on the government debt, in 1991. Mr. Skånland stressed that the dependence on oil makes the Norwegian economy vulnerable to falls in the oil price.

The central bank governor said it was crucial for Norwegian business and industry to be able to adapt once stiffer competition makes itself felt in certain areas of the economy. The ability to adapt depends on how well we manage our natural resources, our labour and our capital. He stated that the impending tax reform is aimed at improving our use of capital. The reform should be implemented as quickly as possible, not least because business and industry will otherwise face a prolonged period of uncertainty regarding the future regulatory framework.

Mr. Skånland also emphasised that the wage level is the key to achieving the required competitive strength. If there is a reasonable balance in the external economy, concurrent with a satisfactory employment level, wage costs cannot be said to be excessive. However, neither the employment level nor the state of the external economy is such that Norway could bear any increase in its relative cost level: the opposite is what is needed. He stated that the only way to achieve a sustainable high employment level is to enhance labour market flexibility, and to put wages onto a path more beneficial to product market competitiveness. It must primarily be up to the labour and management organisations to ascertain to what extent this requires revision of the actual process of wage formation and what can be achieved within the framework of this process.

The Governor also emphasised that the merit of the fixed exchange rate policy pursued in recent years was further confirmed by the pegging of the krone to the ecu on 22 October last year. The authorities' recourse to devaluation to combat business and industry's cost problems is now a thing of the past.

Mr. Skånland cited the realisation in most countries that, given the way the labour market works, the authorities have few other means of stimulating employment than public spending increases, which is apt to lead to a weakened external economy, inflation, or both. However, this form of "job-creation" reduces the sustainability of employment in the long term. As long as demand could be stimulated using oil revenues, Norway escaped having to face up to this realisation. However, increased use of oil revenues cannot be continued. The notion that the state is responsible for employment, which appears more deep-rooted in Norway than in other countries, is a threat to employment since it undermines an understanding of the responsibility of the social partners.

In discussing the international economy, Mr. Skånland pointed to fears that problems of financial institutions in many countries will contribute to weaker economic growth. He emphasised the importance of fruitful collaboration among central banks to secure the stability of the system.

In his discussion of the Norwegian financial system, Mr. Skånland said:

"In the financial markets the distribution of responsibility should be clear enough in principle. Profits and financial strength are the responsibility of the individual institution. However, the statutory framework must give institutions the freedom of action to exercise this responsibility. The Banking, Insurance and Securities Commission ensures compliance with the legislation, both in formal and real terms, while Norges Bank ensures the supply of liquidity in accordance with guidelines laid down by the political authorities. Moreover, Norges Bank, like other central banks, is responsible for ensuring that difficulties which may affect the individual financial institution do not undermine confidence in the country's financial system. The question of appropriate response in such cases, particularly on the part of the political authorities, was addressed in the White Paper on Sparebanken Nord-Norge. Moreover, the general weakening of financial institutions' capital as a result of the losses of recent years has given added focus to the question of how the political authorities should exercise their responsibility in practice.

The background to the grave problems facing the banks is illustrated by the loss trend. Whereas bank losses constituted less than 0.5 per cent of loans up to 1986, the ratio rose sharply in 1987. In the past three years, losses have constituted 2-2½ per cent of loans per year. As a result, the banks as a whole have been in deficit after actual losses, or at best broken even. Their reserves have been eroded, which has made it difficult for them to attract fresh capital by issuing shares and (in the case of savings banks) primary capital certificates. Moreover, their net interest revenues have weakened owing to a decline in interest earned on capital. The problems are compounded by the fact that financial institutions are required to raise their capital to comply with international capital standards adopted by Norway by the end of 1992.

The public debate is still concerned with apportioning responsibility for the financial crisis. In my 1989 address, I pointed to three factors: bad banking, bad policies and bad luck. This terse description was later confirmed in quite extensive analyses. Thus there is no reason to continue the hunt for scapegoats. We should instead concentrate on what can be done to rectify the situation in the individual bank, by banks collectively through their guarantee funds and by the authorities.

The most important tasks will of necessity rest with the individual bank. They fall into three groups.

First, the banks must reduce losses by improving routines for granting loans and monitoring engagements. This applies both to non-performing and performing loans. It is also important to discourage a decline in payment morals, both on the part of corporate and personal customers.

Second, costs must be reduced. This implies staff reductions and closure of bank offices. Much has been done in this respect, but the process could undoubtedly be pursued further. For the public it means putting up with reduced service, and in some cases reduced local competition.

Third, an increase in revenues is necessary. This involves raising service fees, but in particular a wider interest spread within the fairly narrow limits set by competition with other financial institutions.

To the extent this leads to higher lending rates, it clearly has detrimental effects both on business and industry and on households and thereby on the entire economy. However, the same groups and the economy are also jeopardised if the banks lack the capital base required to fill their functions in the economy. In view of the new capital adequacy standards, the banks will be compelled to implement all the measures at their disposal.

In this difficult period the two bank groups' safety nets have made important contributions to securing stability in the banking sector. The decision before Christmas to allow the commercial banks' deposit guarantee fund to provide member banks with capital in the form of preference shares is a useful further step in securing the financial strength of banks potentially in danger of failing to fulfil the capital requirements. However, in view of the efforts already made, and those expected to be made by the guarantee funds, their resources are for the most part already committed.

Norges Bank has assisted in resolving the problems in the financial markets by injecting liquidity, once the banks' guarantee funds have put up the required security. However, the central bank administers public funds which it cannot deploy as risk capital unless some form of political decision has been taken to this effect. And when the question arises of taking political decisions to deploy resources, the appropriate instrument is the Government Budget.

Since the deposit guarantee funds have limited resources at their disposal and doubt could therefore arise about their ability to perform the functions they have assumed or will be confronted by, the government has proposed to the Storting the establishment of a Government Bank Insurance Fund. If necessary, this fund can provide loans to the deposit guarantee funds. This should serve as a convincing demonstration of the authorities' determination to secure the stability of the system.

However, there will be no easy access to the government fund. Its establishment provides no reason for the banks to take a lax view of their own measures to strengthen their earnings, and neither owners, staff or the general public should expect this fund to dispense any form of business support of which they will ultimately be the beneficiaries. We will have to pay the bill for the lending spree of the 'eighties in many ways, and the bill will be no smaller if we meet it as taxpayers. On the contrary, bills paid by this means have a tendency to expand.

The fund is to be established as a temporary measure in a period of crisis. Only when the fund becomes redundant because the banks have strengthened their earnings to the point where they can build up and procure capital in the market unaided, will we be able to say that the crisis has been overcome. However, the Norwegian community will also need its banks in the meantime, and the support they receive will therefore be in the community's own interest.

However, for Norwegian business and industry the international integration of financial markets means less dependence on the position of Norwegian institutions than was earlier the case. There are no constraints on raising loans abroad, and foreign banks have set up operations in Norway, in some cases through taking over Norwegian banks. In 1990, 50 per cent of the total credit supply came from foreign sources, whereas foreign banks established in Norway accounted for 12 per cent of bank lending growth but for only 1¼ per cent of total bank loans.

The continuing process of integration within the framework of an EEA agreement will probably accord non-residents easier entry into Norway's financial sector, also through takeovers of already established financial institutions. For users of the financial markets, it may not matter much whether financial institutions are owned by residents or non-residents. Nonetheless, most countries consider it important for the largest finance enterprises to be in domestic hands. A similar attitude appears firmly established in Norway, based, as the case may be, on economic assessments or national sentiments. This attitude is a reality which must be taken into account in the shaping of regulations governing financial institutions."

Mr. Skånland concluded his address with a reference to recent years' shift towards growing confidence in the market. He stated that the dividing line between the market's and the government's responsibility will never be ultimately defined. However, given our tendency to turn to the government to avoid footing the bill ourselves, the market would seem to be in greater need of an advocate.

In the field of environmental protection, he nevertheless saw a clear case for stronger government involvement. This, however, Mr. Skånland would regard less as market intervention and more as an extension of an area in which market principles are at work; the government would then act as the price setter on natural resources which would otherwise have been free. This is feasible on a national scale, but internationally there is no agent with sufficient insight and authority to set a price on resources, such as the atmosphere, which are not subject to territorial jurisdiction but whose exhaustibility we are now becoming increasingly aware of. This is where our national interest in and the international necessity of integration merge. Mr. Skånland stated that international bodies are at present unable to implement solutions to international environmental problems, and that this makes further integration a global necessity.