Norway and the UK

Speech by Governor Svein Gjedrem at Lloyd's of London, 26 October 2005

The speech does not contain assessments of the economic situation or the monetary stance. Please note that the text below may differ slightly from the actual presentation.

Introduction

The UK and Norway are bound together by a common sea and a common history. For centuries our ancestors have been crossing the North Sea, affecting the way our two nations have evolved. In the 9th and 10th centuries, Norwegian Vikings rampaged through the British Isles, settling and imposing their way of life on the Britons. Since then, I am happy to say, a more civilised form of interaction has determined our relationship.

An event which had a considerable impact on Norwegian shipping and economic history took place in 1849 when England repealed all navigation acts regulating the right to transport goods to and from England and its colonies.

As a small, mountainous country, Norway has always been dependent on trade with the outside world. This new and more competition-friendly trade environment spurred the rapid build-up of the Norwegian commercial fleet. As the chart shows, the commercial fleet grew six-fold from around 1850 to 1880. By 1880, Norway had built up the world's third largest commercial fleet. As a result of freer trade and the entrepreneurs of the time, Norway moved from being a poor country to its future as an industrialised nation.

The UK is a centre for world shipping, and Norwegian ships to this day visit British harbours more frequently than any other harbours in the world. A large number of Norwegian companies in shipping, ship financing, shipbroking and maritime insurance also have bases here.

The UK and Norway enjoy strong and close bilateral trade relations also in other areas. The UK is our single largest export market and the UK is the third largest supplier of Norwegian imports.

Economic policy and the Petroleum Fund

Our common sea offers sizeable resources in the form of energy. A wide range of potential cross-border oil and gas projects, including pipelines are currently being discussed by our governments. One major project is the transport of gas from the Ormen Lange field through a new pipeline to the UK. The huge gas field, whose name means "the long snake", is named after a Viking ship built in the year 996 AD by King Olav Tryggvason. It was said to be the biggest ship of its day and is celebrated in the Norse sagas. The export of gas from this field will cover up to 20 per cent of the UK's annual gas demand, and account for 20 per cent of Norway's annual gas production.

Petroleum activities give Norway an economic base that is not available to many other countries. But it also presents us with many challenges.

First, our petroleum resources are part of our national wealth. When oil is extracted and sold, petroleum wealth is transformed into financial assets. This wealth belongs not only to our generation, but also to future generations. We must therefore distribute our petroleum wealth equitably among generations.

Second, the size of the cash flow from petroleum activities also varies. If petroleum revenues were to be used as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy, which would also amplify cyclical fluctuations.

Third, the use of petroleum revenues has an impact on competitiveness in Norwegian business and industry. A high level and substantial variations in the use of petroleum revenues would have a negative impact on internationally exposed industries.

The establishment of the Government Petroleum Fund and the spending guidelines for petroleum revenues are intended to meet these challenges[1].

The government earns large net cash flows deriving from the oil companies' sale of petroleum products in foreign markets. The Petroleum Fund serves as a buffer between current petroleum revenues and spending these revenues in the Norwegian economy. All central government revenues from petroleum operations shall be transferred to the Fund.

According to the fiscal rule that has been approved by the Storting (the Norwegian parliament), petroleum revenue spending shall be limited to 4 per cent, or the expected annual real return on the Petroleum Fund over time. This partly insulates the economy from fluctuations in oil prices and extraction rates in the petroleum sector - and when followed it ensures that revenue spending in the Norwegian economy 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.

The Petroleum Fund also functions as a buffer and dampens the wide fluctuations in the krone exchange rate that petroleum revenues might otherwise have generated. Operators in the foreign exchange market may at times have a tendency to underestimate the Fund's function as a stabilisation mechanism. The capital outflows through the Fund contribute to both curbing the appreciation of the krone and maintaining its stability.

The chart shows the krone exchange rate, as measured by the trade-weighted exchange rate index (TWI), and oil spot prices from 1999. The chart indicates that there is no clear relationship between the nominal exchange rate and oil spot prices over time. An appreciation of the krone has accompanied higher oil prices in some periods and lower oil prices in other periods.

Since the introduction of the inflation target in March 2001, the correlation has been about zero. This may indicate that the Petroleum Fund has insulated the nominal exchange rate from movements in oil prices. There is therefore cause for some optimism regarding the possibilities of insulating the mainland economy from volatile oil prices in the short and medium term. In the long run, however, we cannot insulate the real exchange rate from developments in the petroleum sector or the spending of petroleum revenues.

The Fund as a means of saving

The Petroleum Fund is also a savings fund that allows petroleum wealth to be distributed across generations.

Since 1996, a considerable portion of the petroleum revenues has been retained in the Petroleum Fund. The chart shows the annual revenues from petroleum activities and the amounts of petroleum revenues that have been transferred from the Fund to the government budget.

At the end of the second quarter of 2005, the market value of the Petroleum Fund's portfolio was roughly 65 per cent of GDP. As shown in the chart, the Fund will probably grow strongly over the coming years. On the other hand, Norway, like many other countries, is facing substantial fiscal challenges, not least as a result of higher pension expenditures.

Increased saving today may be a way to address this challenge, but this is not enough in itself. In the long term, the most important factor will be how we manage our national wealth.

Our petroleum revenues are invested without home bias. In fact, our objectives are best achieved by investing the capital in the Petroleum Fund outside the Norwegian economy. Naturally, the UK as one of the world's leading financial centres plays an important role in this context. According to the benchmark portfolio, 17 per cent of the equity portfolio and 8 per cent of the fixed income portfolio is invested in the UK, making the UK the second largest market for portfolio investment after the US.

Moreover, Norges Bank has located one of its offices for management of the Petroleum Fund in London.

Monetary policy

Let me turn to monetary policy and price developments. Inspired by the Bank of England, Norges Bank last year finalised a large project on historical monetary statistics for Norway, spanning 500 years of price history. The statistics show that price stability has been the norm over this period, with the exception of a few episodes of substantial and lasting changes in the price level. Interestingly enough, price developments have generally been the same for Norway and the UK. The most notable exception was the strong increase in prices in Norway during the Napoleonic wars.

Looking at more recent history, both Norway and the UK had to abandon their fixed exchange rate policy in 1992. Important reasons were freer capital flows and deeper financial markets, with a surge in cross-border capital movements.

The UK switched to inflation targeting in 1992 and was one of the first countries to introduce a system that would later become the norm for small and medium-sized economies. The

Bank of England succeeded fairly quickly in anchoring inflation expectations and keeping inflation low and stable in the UK.

Norway followed suit in March 2001. When we adopted the new monetary policy regime, we were in the fortunate position of being able to look to the Bank of England and learn from their experience. It also helped that agents in international financial markets were already familiar with the concept of inflation targeting. So, in many ways, the Bank of England had already paved the way for us.

Going forward, however, past success in stabilising the economy may have created excessive confidence among economic agents in what inflation targeting can achieve.

Final remarks

Coming back to the close ties between our two countries, these ties are not only of an economic nature. We cross the North Sea for purposes other than business. Each year around 200 000 British tourists visit Norway, and over 500 000 Norwegians visit the UK.

The British were among the first tourists to come to Norway, exploring Norwegian fjords and mountains as early as in the 1850s. One of the earliest travel operators was an Englishman called Thomas Bennett, who began organising tours of the Norwegian mountains for adventurous Britons.

While the British come to Norway for the fjords and mountains, Norwegians flock to the UK to experience big-city life and real English football.

Norwegian fans have been obsessed with English football since Norsk Tipping, Norway's leading betting company, introduced weekly football pools in 12 matches from the English league in 1948. When the Norwegian Broadcasting Corporation first began to televise Match of the Day in 1969, this obsession grew. Of the 92 professional clubs in the British league system, about half now have supporters' club branches in Norway. Manchester United's is the largest, with around 35 000 members.

Thank you for your attention.

Footnotes

[1] See Act relating to the Government Petroleum Fund, adopted on 22 June 1990 and amended by Act no. 2 of 16 January 2004.