Current and future financial and monetary outlook

Harald Bøhn, Executive Director. Oslo Stock Exchange Seminar, New York, 5 November 1999

First I would like to express my appreciation for this opportunity to present some features of the Norwegian economy. I will start by focusing on Norwegian monetary policy, then make some comments about the Government Petroleum Fund, and conclude by briefly touching on the situation in the financial sector.

Last winter the uncertainty associated with economic developments was greater than normal. There was a risk that the weakening of the krone and the high level of wage growth peculiar to Norway could become self-reinforcing and trigger an acceleration in inflation. Nor could we rule out the possibility that the Norwegian economy would move in the opposite direction, into a deflationary recession.

The budget for 1999, as adapted in November of last year, and the wage settlement last spring contributed to reducing the uncertainty. Moreover, the setback in Asia proved to be temporary and the crisis in Latin America had a more limited impact on the global economy than feared. In addition, higher oil prices are contributing to growing optimism in Norway.

There is still uncertainty associated with the economic outlook. We expect the mainland economy to expand at a slower pace than the growth in output potential both this year and next, with the attendant effect of curbing labour market pressures. However, the projections in our latest inflation report indicate that mainland growth will be approaching its trend level during 2001. It is important to bear this in mind when formulating economic policy. At the same time, price and cost inflation may be brought into line with the level aimed at by the European Central Bank.

The economic prospects outlined in the National Budget for 2000, which the Government presented in October, are very similar to those projected by Norges Bank.

Monetary policy

The focus on monetary policy has been unusually strong in Norway in recent years. The discussion has shown that not all aspects are fully understood. Norges Bank is particularly concerned with monetary policy credibility. I would therefore like to contribute to clarifying the monetary policy conducted by Norges Bank. The Norwegian krone is floating, but it is a managed float. The monetary policy to be conducted by Norges Bank is stated by a mandate dated 6 May 1994.

The mandate says that monetary policy shall be aimed at maintaining a stable krone exchange rate against European currencies based on the range of the exchange rate maintained since the krone was floated on 10 December 1992. Since 1 January 1999 Norges

Bank has used the exchange rate against the euro as a reference, whereas the ECU was used earlier.

The mandate for monetary policy is formulated on the basis of the experience of the fixed exchange rate policy that applied earlier in the 1990s. However, Norges Bank no longer pursues a traditional fixed exchange rate regime with fluctuation margins and an intervention obligation.

If one must compare the present regime with the fixed exchange rate regime, the "initial range" must be interpreted as a broad indication of a central rate and not a band within which the krone is to be maintained at all times. The Exchange Rate Regulation also provides for significant changes in the krone exchange rate in relation to the initial range, as was the case last year when commodity prices plunged. In such a situation instruments are to be oriented with a view to returning the exchange rate over time to its initial range.

The expression "significant changes in the exchange rate" has not been quantified and the concept must be given an economic content. A reasonable interpretation is that we have a "significant change" when the exchange rate movement influences price and cost inflation to the extent that changes in the exchange rate become selfreinforcing.

The expressions "with a view to", "over time", "aimed at" and "based on" also show that Norges Bank has considerable scope for exercising discretion.

In exercising discretion, Norges Bank emphasises on the fundamental conditions for achieving exchange rate stability over time. Price and cost inflation must be brought down to the level aimed at by the ECB. At the same time, monetary policy must not in itself contribute to a deflationary recession.

I have noted that some observers interpret this as a shift in Norges Bank's monetary policy. This is not the case. The Exchange Rate Regulation remains unchanged and the scope for discretion is the same, but the result of the discretion exercised will be different according to the situation at hand. And the setting of interest rates last autumn should be considered as consistent with what I am conveying in my presentation today.

Norges Bank raised interest rates in 1998, when the krone was still at the strong end of the so-called initial range. At this point the Norwegian economy showed clear signs of overheating. Price and cost inflation was rising, particularly as a result of high wage growth. At the same time, oil prices fell, we were hit by turbulence in international financial markets and there were signs that these developments would undermine confidence in the krone. As a response, Norges Bank raised its key rates seven times in 1998, by a total of 4 1/2 percentage points. After the last rate increase on 25 August, the deposit rate was 8 per cent and three-month money market rates were close to 4 percentage points higher than in the ECU area.

The sharp increase in interest rates was not sufficient to return the krone to the initial range in the short term. Nevertheless, Norges Bank's assessment was that further interest rate hikes would not strengthen the krone. The decision to stop at 8 per cent was based on an assessment of what would be perceived as a credible monetary policy stance. The interest rate level established was not so high that it would prompt an abrupt turnaround in the economy, with a sharp rise in unemployment, but still high enough to lower inflation expectations.

Norges Bank sets interest rates with a view to achieving the fundamental conditions for exchange rate stability. We cannot focus on daily exchange rate quotations.

Norges Bank does not have the instruments for fine-tuning exchange rate movements. Any attempt at such short-term fine-tuning of the exchange rate may undermine the fundamental conditions for exchange rate stability over time. The krone exchange rate must also be expected to vary in the future. The exchange rate is influenced by international financial markets, changes in oil prices, budgetary policy and price and cost inflation. It is not rational to conduct a monetary policy that takes into account daily exchange rate movements, while ignoring the basis for exchange rate stability over time.

The Regulation's requirement as regards returning the exchange rate over time to its initial range may - if stretched - imply an excessive element of parity policy. For example, in a hypothetical scenario with a sharp and prolonged fall in oil prices, the krone exchange rate may remain outside the initial range for some time. If Norges Bank responds by raising interest rates in order to force the exchange rate back to its initial range, monetary policy could lead to a deflationary recession. Similarly, after an appreciation, a situation may arise in which a movement of the exchange rate back to the initial range would require interest rates to be reduced to levels where monetary policy generates inflation. In both cases this would weaken the basis for exchange rate stability over time. Hence, Norges Bank cannot with open eyes orient monetary policy instruments towards triggering inflation or a deflationary recession.

If a situation arises where Norges Bank is not able to return the krone to its initial range without such consequences, the Bank will inform the authorities that measures other than those available to the central bank are required. One possibility could then be to recommend fiscal measures that make it possible to bring the krone exchange rate back to its initial range and stabilise it. In the event of major and lasting shifts in the economy, fiscal policy and wage formation must contribute to restoring balance in the economy. However, if fundamental conditions were to be permanently changed for the Norwegian economy, it may also be appropriate to consider changes in the guidelines for monetary policy.

Such measures may, depending on the situation, be fiscal policy measures or changes in the monetary policy regime or the initial range. However, let me emphasise that these are hypothetical situations. The present exchange rate range has more or less prevailed for ten years. On the basis of its analyses, Norges Bank does not find grounds to maintain that this range is not the appropriate one.

Norges Bank has reduced its key rates in five steps by a total of 21/2 percentage points so far in 1999 based on its assessment of how we can best achieve the fundamental conditions for a stable krone exchange rate. In this assessment, we of course take into account actual developments in the exchange rate.

Our Inflation Report indicates that price and cost inflation in Norway will gradually slow to the level aimed at in the euro area. Based on the developments as indicated in our analyses, this leaves little room for further reductions in interest rates. But it is more likely that the next change will involve a reduction rather than an increase. If developments are in line with expectations, any further reduction will, however, be smaller than the reductions implemented so far.

Let me then turn to the Petroleum Fund and its role in economic policy.

The Government Petroleum Fund

A salient feature of the Norwegian economy is the importance of oil revenues, which may fluctuate considerably from year to year. The Government Petroleum Fund was established for many purposes. It is a means of storing wealth and redistributing income from oil extraction between generations, of buffering against changes in oil prices, and of facilitating demand management. Thus, the Fund facilitates the fiscal policy tasks of maintaining the desired size of the exposed sector and stabilising the economy.

North Sea oil and gas reserves are part of Norway's economic wealth. Extracting the oil and allocating the revenues to the Government Petroleum Fund is a way of transforming this wealth into financial assets abroad. The purpose of accumulating capital in the Fund is to redistribute petroleum revenues between generations and ensure the long-term stability of state finances. The larger the Fund, the less dependent Norway will be on petroleum revenues in the future, and the more prepared we will be to meet the challenge of an ageing population.

Furthermore, the Petroleum Fund is to act as a buffer against short-term variations in petroleum revenues by separating the cash flow from oil extraction from current expenditure. Since a large share of the revenues from petroleum activities accrues to the state, any fluctuations in oil prices will primarily result in changes in allocations to the Fund. Since all of the Fund's capital is invested abroad, such changes will in principle not influence economic activity. This makes the Norwegian economy more robust to oil price fluctuations, thereby reducing oil dependence in the short term.

To illustrate the importance of the buffer function, note that an oil price increase on the margin will be reflected mainly in an increase in government revenues and will have little effect on private sector incomes. This means that the effect of the price increase on the Norwegian economy depends on how the government spends the additional revenues. If they are absorbed into the economy through higher expenditure or reduced taxes, when the economy is already nearing capacity, such a policy would rapidly lead to substantial pressures on resources in the economy. The Government Petroleum Fund is designed to channel the revenues resulting from such an increase in the oil price to the Fund for investment abroad, in order to prevent an increase in oil prices from influencing the budget. The increased revenues would thus not have an impact on the domestic economy, but be invested abroad through the Petroleum Fund.

The current account balance and government budget surplus show that Norwegian consumption has adjusted to petroleum wealth by increasing net imports and by maintaining a budget deficit excluding petroleum revenues. At the same time some of the wealth is saved abroad to redistribute income between generations.

Compared with many other countries, Norway is in a fairly favourable position as regards its possibilities for conducting an active counter-cyclical policy using government budgets. While many countries are struggling with difficult state finances and have to concentrate budgetary policy on reducing government debt, Norway has far greater scope for manoeuvre. However, Norway must also avoid a situation whereby the central government undertakes long-term and permanent financial commitments to stimulate the economy during a recession.

I have touched on the macroeconomic implications of the Government Petroleum Fund. Let me also say a few words about the management of the Petroleum Fund. Even though this involves Norwegian foreign investments and not "Investment in Norway", I believe there is some interest in the Fund's operations in the financial community.

Management of the Government Petroleum Fund

Norges Bank manages the Government Petroleum Fund on behalf of the Ministry of Finance.

The size of the Petroleum Fund is increasing rapidly. According to the Government's projections, the Fund is expected to reach USD 38 billion, or 24 per cent of GDP by the end of 2000. The Fund is likely to continue increasing for the next 20 years, and might in fact, exceed Norway's GDP a decade or two into the next century. This scenario is, of course, dependent on developments in oil prices and fiscal policy.

The Fund was previously invested in interest-bearing instruments, mainly bonds, in much the same way as the Bank's foreign exchange reserves. But in accordance with Norges Bank's recommendation to the Ministry of Finance, from the beginning of 1998, part of the Fund has been invested in equities in the international market to enhance the return on the Fund. The chosen split between equity and fixed income implies some risk diversification, but should on the whole be regarded as a compromise between high expected returns and low annual variability. That kind of compromise is probably familiar to most of you.

According to the guidelines as laid down by the Ministry, 30 to 50 per cent of the Fund can be invested in equities abroad. 20 to 40 per cent of the Fund is to be invested in the US and Canada, 40 to 60 per cent in Europe and 10 to 30 per cent in the Pacific region.

Taking the mid-point of these bands as starting point, a benchmark portfolio for bonds and equities has been constructed using well-defined market indices. The degree of deviation from the benchmark portfolio is subject to a tracking error with an upper limit of 1.5 per cent.

Following a proposal from the Government in the Revised National Budget a separate fund will be established within the Petroleum Fund and will be managed according to specific environmental criteria. The Government has announced that it considers it most realistic to allow the Fund to invest in firms which have published an environmental report or received environmental certification. Clear criteria for how environmental reports should be used still have to be established. Investment according to environmental criteria will most probably start on 30 June 2000.

In the Revised National Budget the Government also announced that it intended to allow an enlargement of the list of countries in which the Petroleum Fund should be allowed to invest. The criteria for selection of countries should be openness, settlement risk, legislation, size and liquidity of the various markets, and in addition political and macroeconomic stability. Norges Bank has evaluated several countries, on the basis of the International Finance Corporation's definition of emerging markets, and found seven countries which are considered to fulfil the economic criteria. In the light of these considerations, the Government aims to include Brazil, Mexico, Korea, Taiwan, Thailand and Greece on the list of eligible equity markets. The guidelines will be changed from 1 January 2000, but these markets will not be included in the benchmark portfolio from the start. Investments in these countries will not be allowed to exceed 5 per cent of the Fund's total investment in equities.

As manager Norges Bank can be able to cope with these changes. As advisers to the Ministry, however, we have pointed to numerous problems and pitfalls associated with formulating and implementing ethical and environmental guidelines. For the central bank as manager, it is essential that decisions of a political and judgemental nature be taken by the political authorities and not left to the central bank.

Let me briefly touch on the situation in the financial sector in Norway.

The financial sector

There is currently a debate in progress in Norway concerning state ownership of Norwegian banks, and the role of foreign banks in Norway. This debate was triggered by the bid put in by the Swedish-Finnish bank Merita-Nordbanken for Norway's second largest bank, Christiania Bank.

Norges Bank does not have a central role in this debate. In individual cases the Bank will be asked to submit a statement before the Ministry of Finance makes a decision regarding an application for a licence. No such application has been submitted in the case in question, so it has not been natural for the Bank to make a statement.

We have seen that both commercial and savings banks in Norway recorded improved operating profit before tax as a percentage of average total assets in the first two quarters of 1999 compared with 1998. Commercial banks recorded the strongest improvement. For both groups, the improved profits were partly ascribable to increased net interest and non-interest income, and partly to reduced operating expenses.

The competitive situation in the financial sector has intensified in recent years, and banks' earnings have come under pressure. Increased interest margins over the last year may indicate that banks are giving higher priority to earnings than to maintaining or increasing market shares. There are, however, many indications that the increase in margins is primarily related to changes in the Norwegian interest rate level.

Pricing loans so that they reflect expectations of increased credit risk and losses will be a considerable challenge for banks in the period ahead. A number of factors indicate that competition from foreign financial institutions will increase further. Prospects for lower demand for credit from households and enterprises also suggest that competition for loans will intensify. Slower credit growth will, on the other hand, contribute to more balanced development in the financial sector, so that banks can maintain their financial strength even if profits should be reduced.