Øystein Olsen: Managing wealth – some thoughts on economic policy and the allocation of national savings

Speech by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at a meeting hosted by the Norwegian Embassy, Rome, 29 November 2012.

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Introduction

European economies are currently going through hard times, with repercussions of the crisis still being felt throughout the world economy. For all of us, it is a humbling experience to observe how closely interconnected markets and economies have become across national borders. My intention here this evening is not to point at solutions to the challenges currently facing the euro area. What I can offer, however, is the perspective of a friendly neighbour and a substantial investor.

In this modest capacity, I hope to sound a note of optimism from a region of Europe that in its recent past went through a grave crisis, which was followed by a series of reforms and, eventually, the return of prosperity. The Nordic experience with the cycle of crisis, reform and recovery might provide some perspective for those European countries now facing similar challenges. I will also make some remarks on the current situation in financial markets in general, and government bond markets in particular, from the viewpoint of a global investor.

Easy money is bad for you

Slide 1: Landes quote

In his book The Wealth and Poverty of Nations the historian David Landes describes how the Spanish empire went into a long period of decline when the flow of Latin-American gold dried up in the mid-17th century. According to Landes, the moral of this story is that "*easy money is bad for you. It represents short-run gain that will be paid for in immediate distortions and later regrets.*"[1] As a country rich in natural resources, Norway has shared and tried to learn from this experience. Perhaps the quotation from Landes also rings true for all those who borrowed cheaply during the boom before 2008, and who now have to face the consequences.

Windfall gains, like large and unsustainable capital flows from abroad, are double-edged. They provide short-term relief from hard choices, but may carry with them hardship in the longer term.

Slide 2: Output gap: A boom-bust economy

After the discovery of oil in the North Sea in 1969, government spending and social programs expanded rapidly in anticipation of future petroleum revenues. We sought to build a bridge across the post oil-shock recession in Europe. But it was a bridge to nowhere. Fiscal policy had fuelled a boom-bust economy. Inflation soared to double digits. A deep recession started in the late 1970s.

Slide 3: Current account balance: Large external deficits

The non-oil tradable sector struggled as costs had increased. By 1977, Norway's current account surplus had turned into a deficit of 12 percent of GDP. Measured in these terms, the deficit was three times larger than that of Italy and Spain last year. Policy had to be reversed and tightened. Many Norwegians saw a decline in real incomes.

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[1] David Landes (1998): The Wealth and Poverty of Nations, W.W. Norton & Company, Inc., N.Y

Slide 4: Output gap: A boom-bust economy

In the early 1980s, the Norwegian economy experienced a new boom, this time fuelled by debt. When oil prices fell in 1986, the Norwegian economy was hit again. We experienced a collapse in house prices, a severe banking crisis, a currency crisis, a fiscal crisis and high inflation. Unemployment soared. Large parts of the banking system were eventually nationalised. In the two years period after summer 1987, GDP fell by almost 5 percent. During the 1980s, Norwegian GDP per capita grew by a mere 1.2 percent annually, less than half of the growth recorded in both the preceding and following decades.

By the early 1990s, the Norwegian authorities realised that the old policy framework was unsuitable for a modernised economy, with deregulated credit and capital markets. The low growth performance and volatility of the recent past was to be replaced by stability, predictability and renewed growth. To that end, several major reforms were implemented, including:

Slide 5: Measures were taken

- a tax reform which lowered tax rates and expanded the tax base,
- abolition of selective support schemes to companies and industries,
- an agreement between unions and employers to improve cost competitiveness, and
- the establishment of the Goverment Petroleum Fund, Norway's sovereign wealth fund.

Slide 6: Two golden decades

A long upturn followed. Norway has not experienced a pronounced economic downturn since the crisis around 1990. The reforms introduced during the 1990s have resulted in a fairly flexible labour market, which has allowed labour supply to adjust to changing conditions. In addition, we have been helped by good fortune in the form of favourable terms of trade. The economy was quite robust when the financial crisis hit in 2008, in sharp contrast to our situation 25 years ago.

The policy climate in Norway in the early 1990s may have some characteristics in common with what we see in parts of Europe today. While short-term challenges need to be tackled urgently, a time of crisis may also provide an opportunity to implement structural reforms. In the case of Norway, the commitment and the capacity to implement reform was a critical condition for renewed and sustainable growth.

The Fund and fiscal policy

The Act relating to the Government Petroleum Fund was passed in 1990. Under the Act, all government revenues from the oil sector are to be transferred to the Fund, and the net budget surplus is to be invested in international markets. At the time, in the midst of a deep recession, many doubted that any petroleum revenues would ever be saved. Projections indicated that offshore petroleum production would peak in the early 1990s. However, during this decade, the government's cash flow from the petroleum sector started to increase sharply.

Slide 7: The fund mechanism and fiscal policy

The policy guidelines were clarified in 2001. Rules governing the interaction between Norway's petroleum wealth and fiscal policy were established. Under the fiscal rule, the government can only spend in the annual budget, on average over an economic cycle, the expected real return on the Fund – estimated at 4 per cent annually.

At the same time, Norges Bank was charged with the task of keeping inflation low and stable. Thus, our traditional fixed exchange rate policy was abandoned. A clear division of responsibilities between monetary and fiscal policy had been put in place.

After two decades of spending petroleum revenues more or less as they accrued, the fiscal rule enabled the government to save for future generations. At the same time, the rule made fiscal policy more robust: By decoupling spending from current petroleum revenues, the fiscal rule provides for a gradual and sustainable phasing-in of petroleum revenue spending.

The fiscal rule is no straitjacket; it allows automatic stabilisers to work. There is also room for some careful use of an active countercyclical fiscal policy when necessary, as was the case when the international financial crisis hit in 2008. Importantly, there must be a corresponding tightening during better times.

Eventually, our petroleum revenues will fall. If we limit ourselves to spending the real return on the Fund, it will provide a perpetual stream to the budget equal to the returns on our financial assets. Thus, in principle, the Fund could be preserved for eternity. If so, Norwegian taxpayers face a permanently lower tax burden for a given level of public services.

Investment strategy

Slide 8: The cash flow grew rapidly

Deposits into the Fund have been substantial, especially for the past 15 years. As it has turned out, governments from different sides of the political spectrum have managed to save a substantial part of our national wealth for future generations.

The Fund has reached a size equal to 130 per cent of GDP, and the fiscal rule allows the government to finance a non-oil deficit of some 5 per cent of mainland GDP through transfers from the Fund.

The investment mandate and the overall strategy of the Fund are determined by the Ministry of Finance. Our task as manager of the Fund is strictly commercial: to maximise returns within the risk limits defined by the government. The Ministry is not involved in actual investment decisions. The Fund is not an instrument in Norway’s foreign policy toolbox.

Slide 9: Key characteristics

The large size, the very long time horizon and a lack of immediate liquidity needs are three key characteristics of the Fund. Together, they form the backbone of the Fund’s investment strategy:

- First, the long-term horizon for the Fund implies a substantial capacity for taking on risk. We are able to act as a countercyclical investor.
- Second, the size facilitates a broader diversification of investments, moving towards a more global portfolio.

In early summer 2007, after a thorough assessment by Fund’s owner, the equity share was to be raised from 40 to 60 per cent. From summer 2007 to 2009, the Fund bought EUR 160 billion worth of equities in international markets. For this sum, the Fund was able to buy 1.0 per cent of Europe’s listed equities – and 0.5 per cent of the equities listed on the other continents. The largest volume of transactions was carried out right through the financial crisis of 2008 and 2009. Indeed, there probably were times when the Fund was the only sizable buyer in the market, which probably helped to stabilise financial markets in this period.

The long-term horizon also enables us to vary the risk level of the Fund, through rebalancing asset classes: If the equity share increases to more than 4 percentage points from the target weight of 60 per cent, we will sell equities and buy bonds. Conversely, we will sell bonds and buy equities when stock prices have fallen.

The capacity to withstand market turmoil was demonstrated during the financial crisis in 2008 and 2009. For a period of 18 months, Fund losses totalled roughly EUR 90 billion – more than 25 per cent of Norway’s GDP. The losses did not go unnoticed and led to a public debate on the investment strategy. The conclusion was that the strategy is robust and that Norway must accept such fluctuations in the Fund's capital, given the high equity share. This point was made clear through 2009 and 2010, when those losses were reversed, and additional gains made. The government remained faithful to the strategy, reaffirming its commitment to the Fund's long-term investment strategy.

The large size of the Fund can also be exploited. Last year the Fund started investing in real estate as a new asset class. The first property investments were made in France, Germany and the UK. We are now preparing for property investments in the US. Direct real estate investments will provide a fairly stable, inflation-adjusted cash flow. Over time, in accordance with the mandate, we aim to invest up to 5 percent of the Fund in real estate. The investments will be allocated to more countries as we gain experience.

Slide 11: Considerable overweight in Europe

The large size and the long investment horizon also entail a need for diversification. From the start, the Fund has been invested with a considerable overweight in Europe. Our average ownership in listed European companies is almost three times our average holdings in Asia or the Americas.

Slide 12: Changing regional allocation (starting point)

At the start of this year, more than half of the Fund was invested in Europe. As the Fund has grown, we have come to realise that a more even distribution between regions will better enable the Fund to take part in global value creation.

Slide 13: Changing regional allocation (target)

Recently, a new principle for the regional allocation of the Fund's assets has been approved. A consequence of this principle is that the relative allocation to Europe is reduced. The Fund's relative holdings in the Americas, Asia and emerging economies will increase accordingly. For the Fund as a whole, a more even allocation across regions will improve the overall long-term trade-off between risk and expected return.

In accordance with the new allocation of the Fund's assets, new purchases will primarily be made outside of Europe, until the adjustment process is completed. As the Fund receives inflows of fresh capital on month-by-month basis, we are able to undertake the adjustment through new purchases. This will ensure a gradual process, and will not entail a large sell-off on our part. Instead, the effect will be merely a temporary drop in our purchases of European assets. Under the new principle, the Fund will still be overweight in European assets, compared to a market neutral position.

Lessons from the crisis

The high equity share, the capacity to increase the risk level in certain periods and the need for diversification are derived from the Fund's characteristics. Let me now review some of the lessons from the financial crisis that have also shaped the development of the Fund's strategy. These changes are closer to the centre of the European debt crisis.

The risk tolerance of the Fund is to a large degree defined by the strategic equity share, which, as I mentioned, is 60 per cent. Since the Fund is heavily exposed to risk by virtue of its relatively high equity share, the function of government bonds is in essence to reduce the overall volatility of the portfolio. From this perspective, the most important role for government bonds is to hedge the equity portfolio.

The hedge is best achieved by holding liquid government bonds with high credit quality. Typically, this entails an overweight of the safest, low-yield government bonds. Conversely, high-yield government bonds are more volatile, and thus they do not serve the overall purpose as a hedge in a global portfolio.

Slide 14: Fixed income: new benchmark

The Fund's benchmark index for bonds is divided into 70 percent public and 30 percent corporate debt. Previously, the allocation in the bond portfolio was based on market weights, and thus the portfolio was allocated in proportion to volume of the sovereign debt issued by each country. This resulted in rising allocation to the bonds of countries with increasing debt. The risk linked to this strategy became clear in the wake of the financial crisis. A reallocation of government debt on the basis of GDP weights will reduce this risk. Moreover, we have started investing in government debt issued by emerging countries. The consequence of this is a reduction in the Fund's European holdings.

Increased demand for the safest government bonds may be regarded as an adjustment to the climate of high spreads and volatility that we have witnessed in recent years. In a market environment characterised by general uncertainty, market expectations might cause a slight increase in risk premiums to mount rapidly, unless the underlying cause of the increased risk premiums is dealt with by the relevant authorities.

To sum up: a downweighting of Europe, the introduction of GDP weights as the basis for asset allocation, and increased risk premiums of certain bonds have all contributed to our present positions. During the past year, the Fund has reduced its exposure to some European government bonds, most notably Italian and Spanish bonds.

Slide 15: Risk has many facets

Credit risk is not the only risk attracting attention in portfolio management. It is our view that unequal treatment of investors during the restructuring of Greek government debt in March this year, contributed to increase European risk premiums. We are happy to notice that President Draghi has underscored that investors would now face equal terms related to the Outright Monetary Transaction programme, as announced by the ECB.

Draghi pointed out another risk factor in July, when he stated that risk premiums are not only linked to default or liquidity, "but they also have to do more and more with convertibility".[2] President Draghi emphasised that this kind of risk is unacceptable. I believe the ECB has taken the relevant measures to eliminate such risks.

Financial investors are risk-averse. They react to signals, expectations about the future and real adjustments. No doubt some European countries have a long and bumpy road ahead of them, before they get their government deficits and debt under control. My message is that positive steps have been made. As a consequence of the measures taken by the ECB, as well as initiatives taken by the European Union and by member states themselves, risk premiums have recently come down. If measures are carried out as intended, it is quite likely that global investors will again allocate the relevant part of their asset portfolios to European government bonds.

Final remarks

Let me return to an overall macroeconomic perspective: to factors decisive for sustainable growth.

The existence of a large, broad-based business sector that is exposed to international competition and trade promotes learning and development. This is true for any country. In countries with abundant natural resources, the exposed sector may easily be scaled back, while sheltered sectors expand. While other economies have been spared having to deal with the curse of cheap credit, US households and European sovereigns have, over the last decade, largely the same story to tell. Easy money is bad for you.

[2] Speech by Mario Draghi at the Global Investment Conference in London, http://www.ecb.int/press/key/date/2012/html/sp120726.en.html

Throughout economic history, mobility of both capital and labour has been an important engine of growth. Today it is discomforting to see signs, albeit small, of financial protectionism. Walls are being erected between countries in the form of investment quotas, taxes and other measures. These walls harm borrowers, savers and investors alike.

Norway is a rich country, and over the years we have benefited enormously from exploiting our bountiful natural resources. However, our future wealth is still conditional on a prosperous future for the whole world. Europe remains our most important trading partner, and still accounts for a large part of our financial investments. We have a large and direct interest in Europe's success.

European economies need to carry out deeper structural reforms to restore competitiveness and growth. The burden of high and rising debt will otherwise become too heavy to carry over time. Until these issues are clarified in more detail, the uncertainty and its associated risk premiums may persist in the market for some time to come.

For Europe, it is now possible to see the light at the end of the tunnel. When growth finally resumes, countries that have improved their economic structures and public finances will be well positioned to take advantage of the upturn.

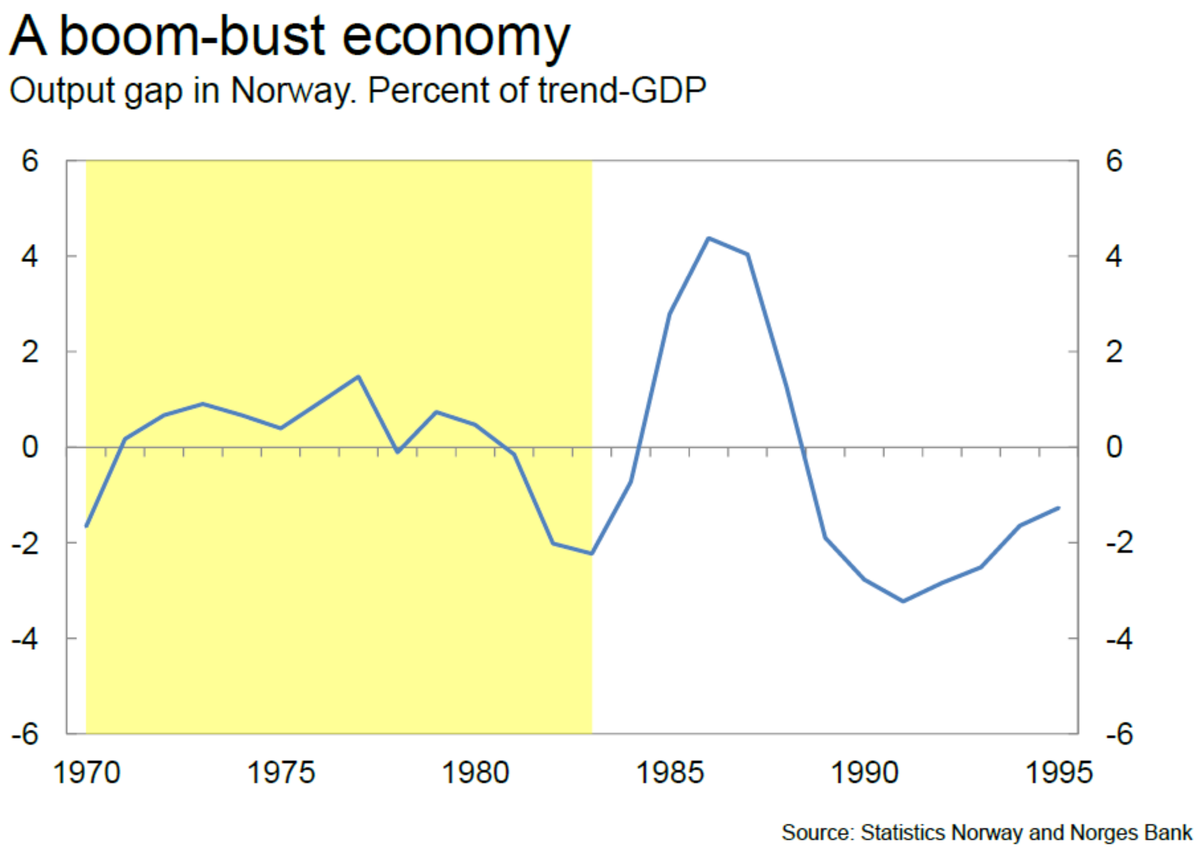
Ladies and gentlemen, thank you for your attention.

Slide 1: Landes quote

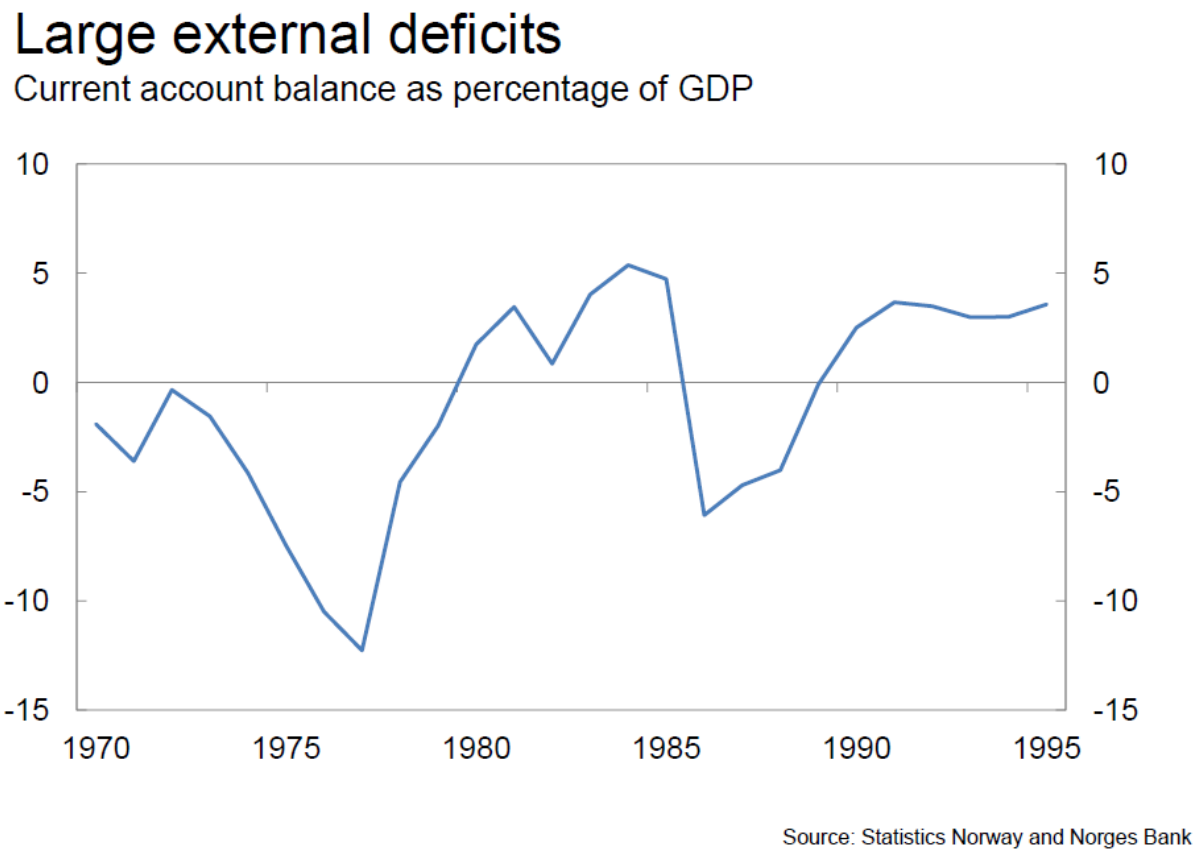
"(..) easy money is bad for you. It represents short-run gain that will be paid for in immediate distortions and later regrets."

David Landes: *The Wealth and Poverty of Nations*, 1998

Slide 2: Output gap: A boom-bust economy



Slide 3: Current account balance: Large external deficits



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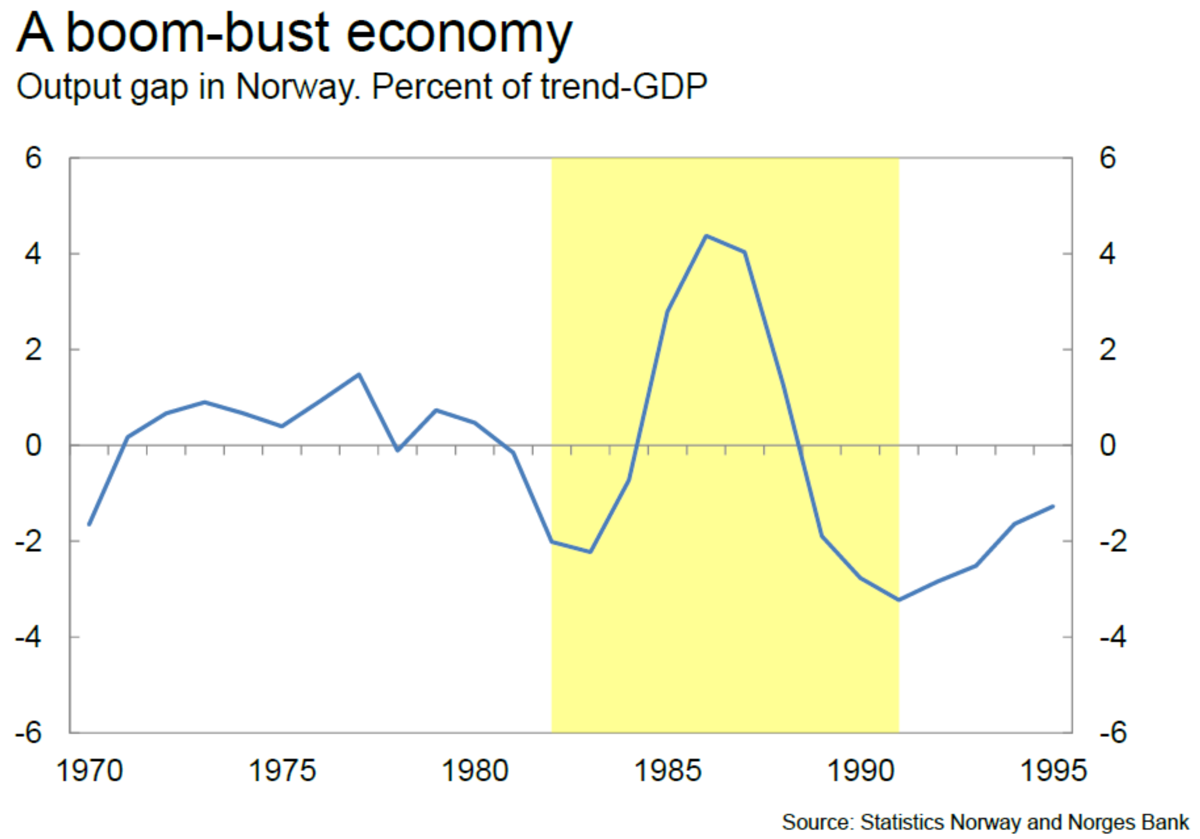
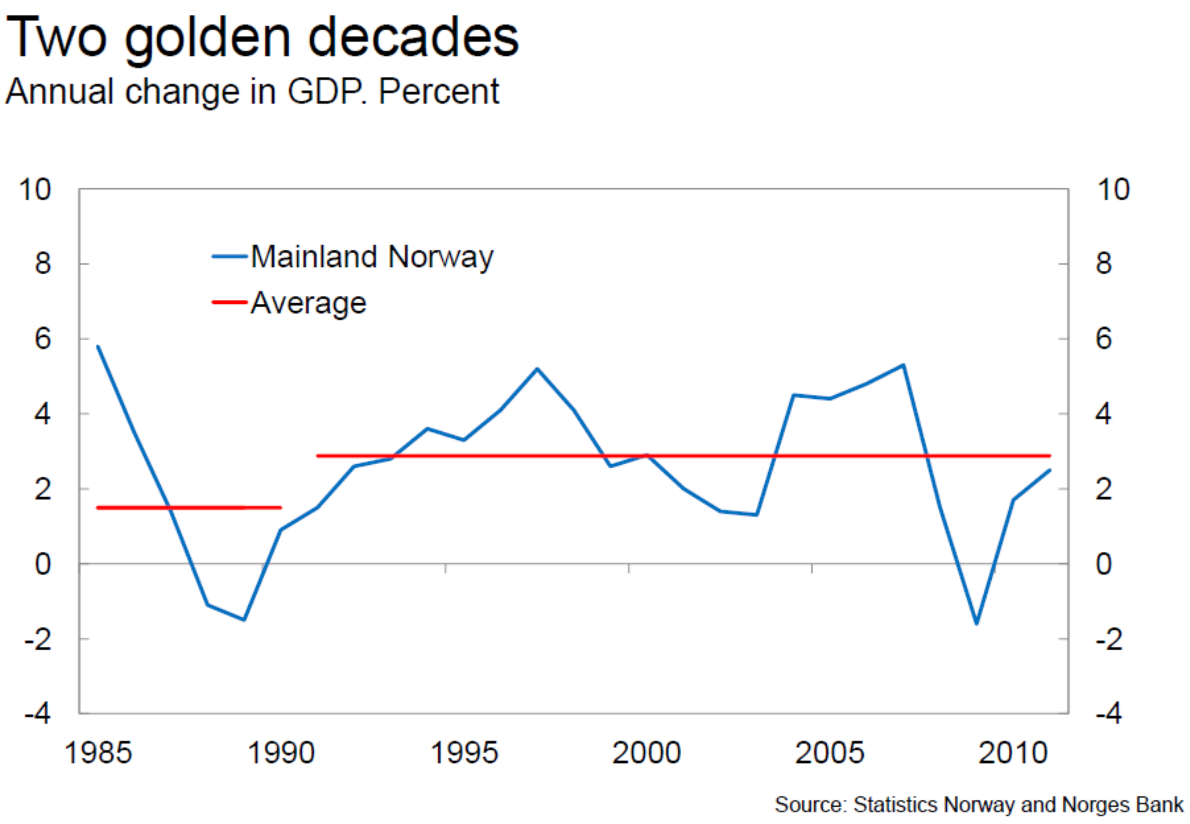


Slide 5: Measures were taken

Measures were taken

- Important reforms early 1990s:
  - Tax system
  - Abolition of support for selective industries
  - Unions and employers
  - Establishment of the Government Petroleum Fund

Slide 6: Two golden decades



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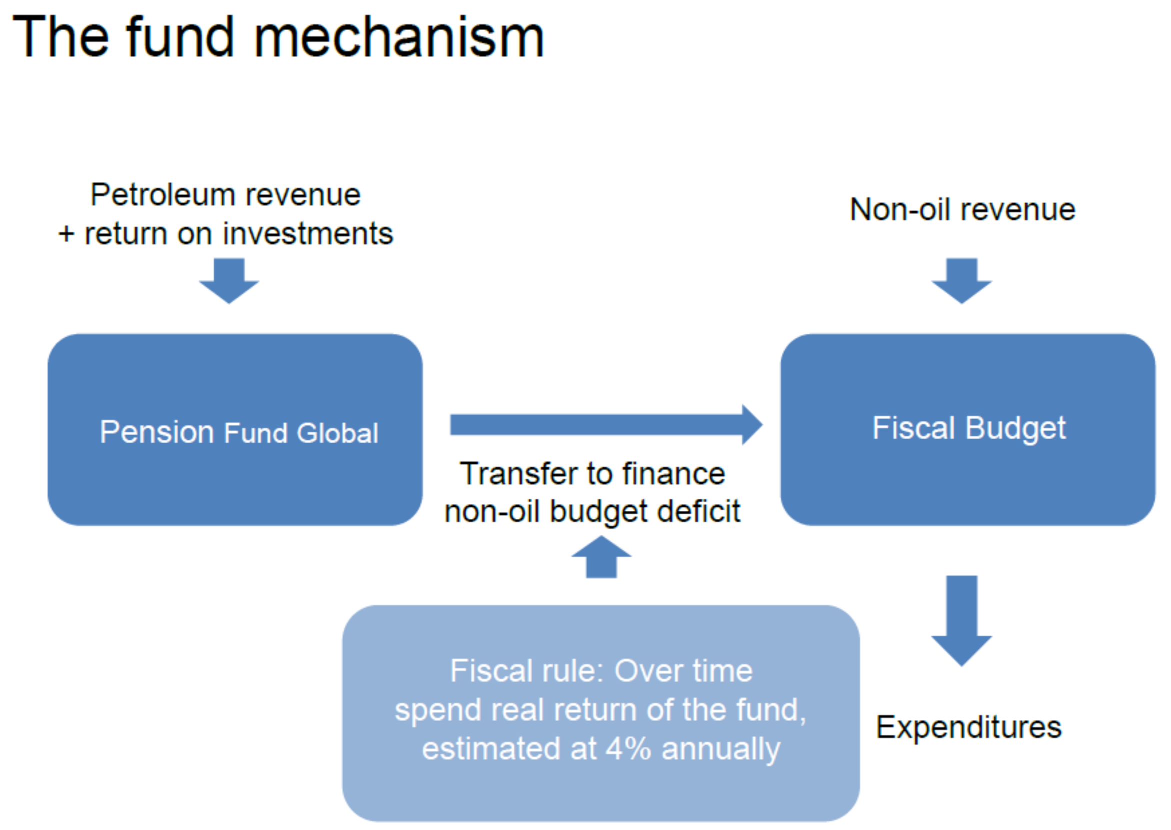
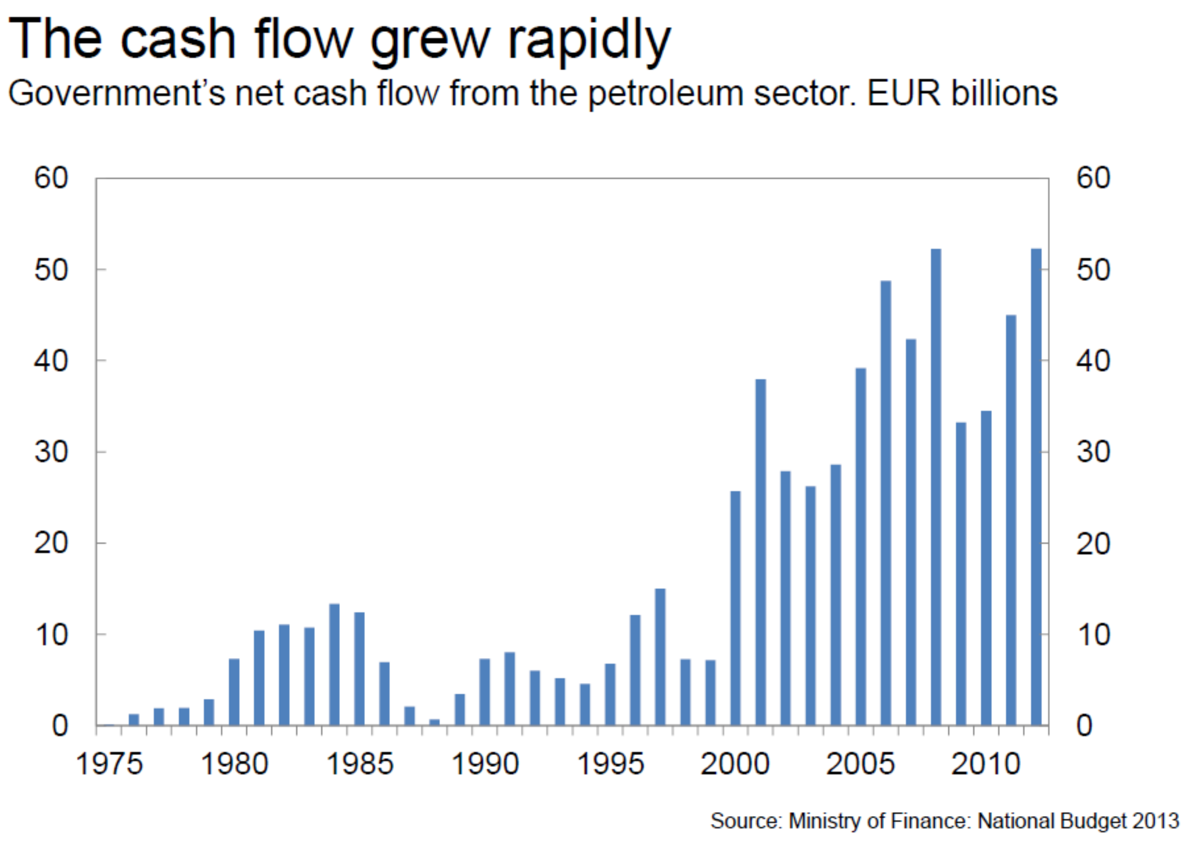


Slide 8: The cash flow grew rapidly



Slide 9: Key characteristics

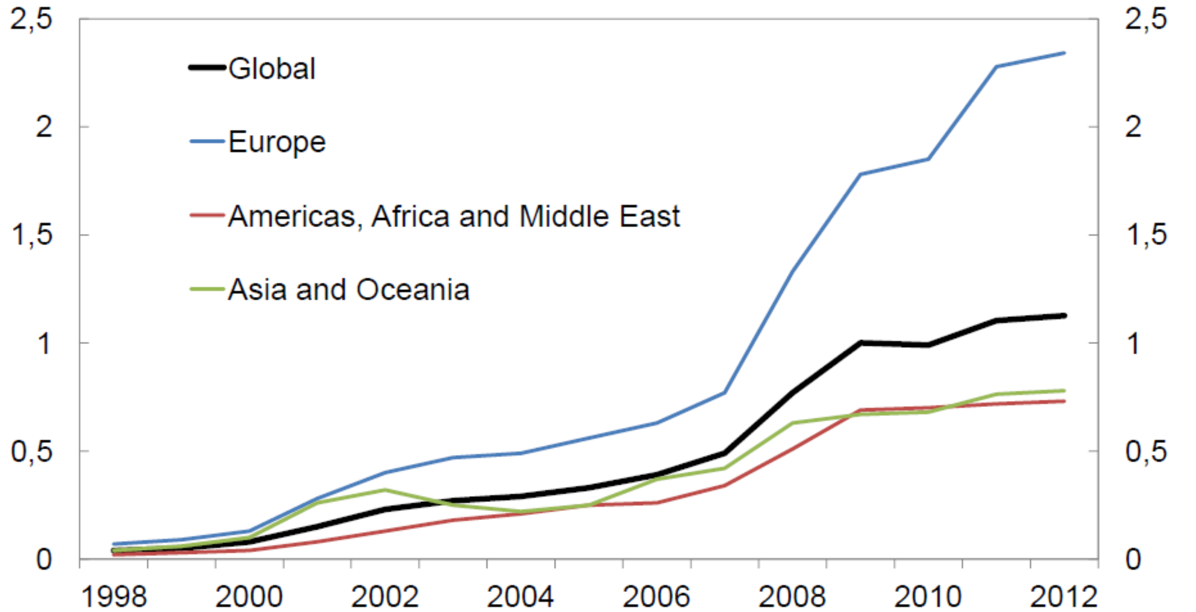
Key characteristics of the Fund

- The fund is
  - large
  - long term
  - with no fixed liabilities

Slide 11: Considerable overweight in Europe

Considerable overweight in Europe

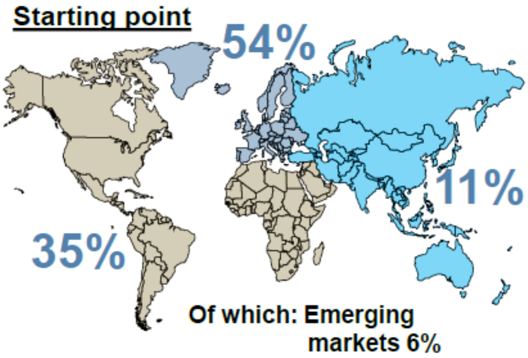
Average ownership interest in equity markets. Percent



Source: Norges Bank

Slide 12: Changing regional allocation (starting point)

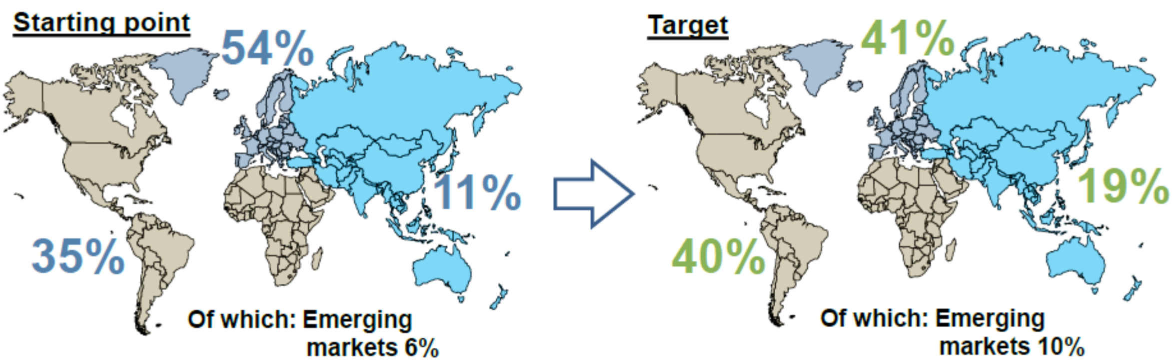
Changing the regional allocation



Source: NBIM, Ministry of Finance

Slide 13: Changing regional allocation (target)

Changing the regional allocation



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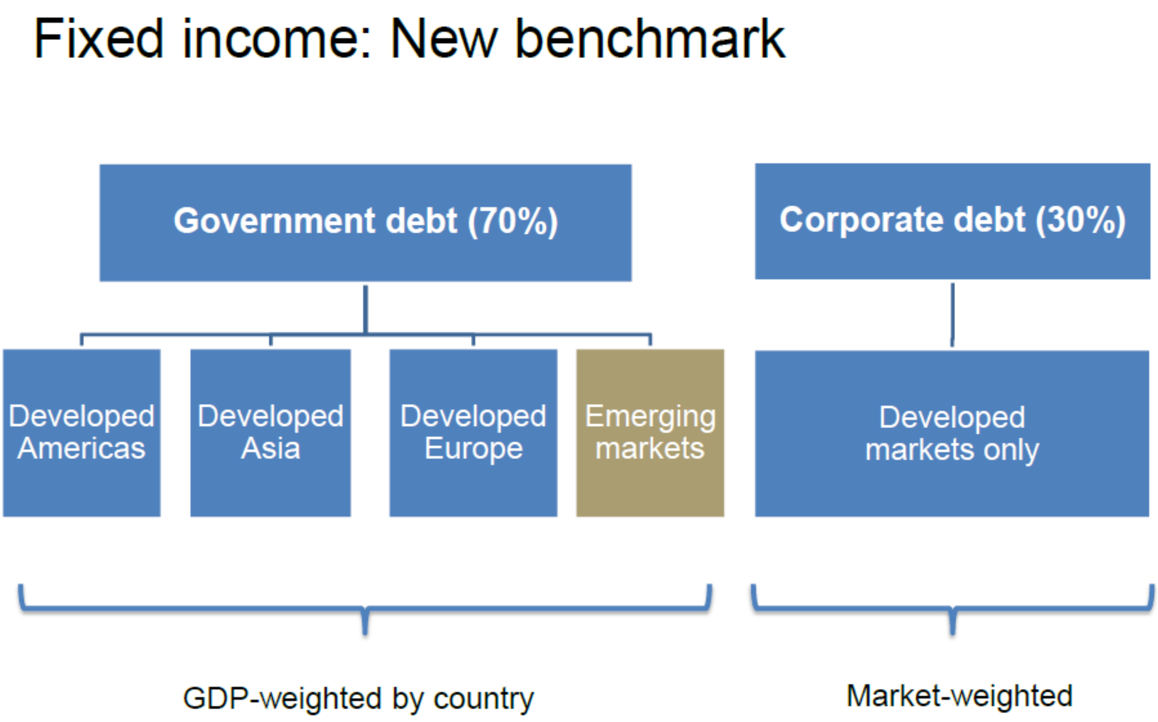
Slide 14: Fixed income: new benchmark



Slide 15: Risk has many facets

There are many facets of risk

*Then there's another dimension to this that has to do with the premia that are being charged on sovereign states borrowings. These premia have to do, as I said, with **default**, with **liquidity**, but they also have to do more and more with **convertibility**, with the risk of convertibility.*

President Mario Draghi, July 26, 2012