Mr Gjedrem reports on economic perspectives in Norway

Annual address by the Governor of the Central Bank of Norway, Mr Svein Gjedrem, at the meeting of the Supervisory Council of Norges Bank on 18/02/99.

Background

Twenty-two years ago, in 1977, the Norwegian economy witnessed the onset of a deep crisis. An economic recession in industrial countries, high price and wage inflation in Norway and the expansion of public welfare services resulted in large current account deficits. Thirteen years ago, in 1986, the Norwegian economy was also in a difficult situation. A debt-financed upswing in consumption and investment, a fall in oil prices and a reduction in working hours gave rise to major imbalances in the Norwegian economy.

In 1998 clouds again gathered over the economic horizon. Costs rose to a high level in Norway compared with other countries, oil prices fell, and the current account balance deteriorated sharply. This signalled a period of sluggish growth following six years of a strong upswing in economic growth and employment. The krone depreciated and interest rates were raised.

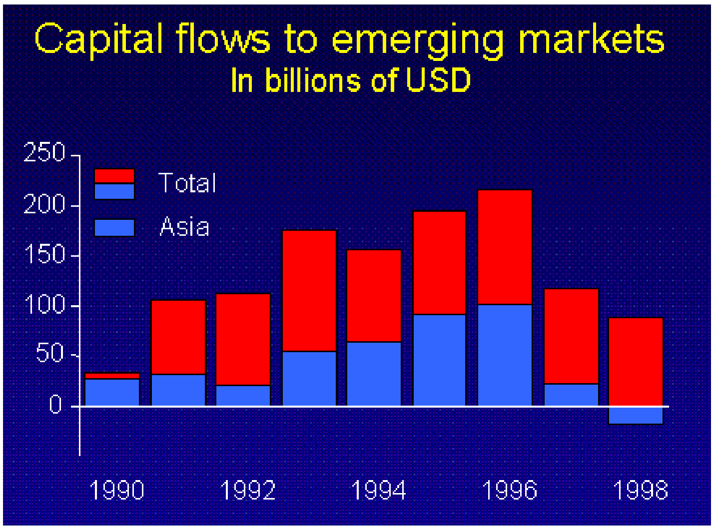
There are many features that distinguish the three turning points in economic developments. However, one common denominator is the sudden shift in the assessment of future oil revenues. Fluctuations in petroleum revenues have proved to be a source of instability in the mainland economy.

Following the last two turning points, the Norwegian economy went through a period of major restructuring, particularly at the end of the 1980s. Today the situation in the Norwegian economy is different. However, this time there is also reason to ask whether we are sufficiently prepared. Is our economy sufficiently robust?

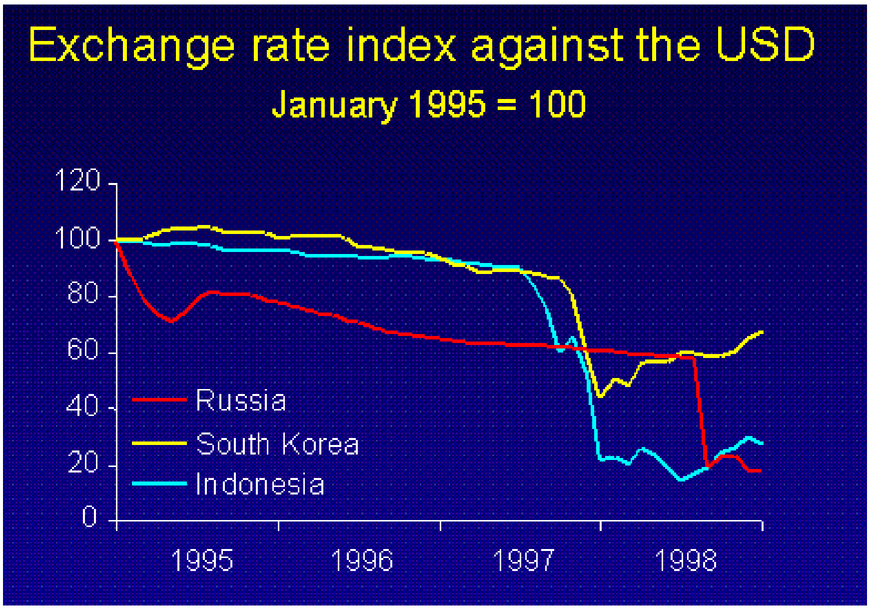
The fall in oil prices was triggered by an international financial crisis and slower growth in the world economy. The Norwegian economy is highly exposed to international fluctuations. Is our own financial system and business sector strong enough to cope with this situation? How should monetary and fiscal policy be formulated in such an exposed and oil-dependent economy? These are the issues I would like to address this evening.

A turbulent world

Even before oil prices started to fall, the warning signals were flashing for everyone to see. The Norwegian economy was overheating in an environment of global economic distress. The signals from Asia were clear.



The problems first appeared in Thailand a little more than 18 months ago, but spread quickly to Malaysia, the Philippines, Indonesia and South Korea. In most of these countries, a sharp upturn had been stimulated by low interest rates and financed through a considerable accumulation of debt in the business sector. Borrowers became increasingly nervous and withdrew capital. Capital inflows from industrial countries were suddenly reversed to massive capital outflows.



Equity and property prices fell sharply and currencies came under pressure. The contagion effect led to a sharp downturn in production and employment. Large population groups that had recently experienced a pronounced increase in living standards slid back into poverty.

The crisis in Asia spread to Russia, where the decline in commodity prices led to an even further deterioration in government finances. The announcement that Russia could no longer service its debt was met with strong reactions in global financial markets in August and September. There were growing fears that the world economy would be caught in a financial crash. Many investors withdrew from small and risky markets, particularly in Latin America. The Brazilian currency came under pressure. It was difficult to raise loan capital even in the most advanced markets. As financial institutions throughout the world experienced growing losses, fears of a world economic depression intensified.

Reductions in interest rates in the US and Europe facilitated access to credit and prevented a market collapse. Measures perceived as credible were finally implemented to resolve the Japanese banking crisis. Additional capital was allocated to the International Monetary Fund.

There are still many challenges ahead. Brazil and Russia are running government budget deficits and are having problems establishing a credible monetary policy. China is bearing substantial costs as a result of the crisis in surrounding countries and may experience difficulties of its own. Other countries may also feel the contagion effect. However, even though the outlook points to lower growth in the global economy this year than forecast earlier, fears of a worldwide depression have receded.

This is by no means the first time we have experienced an international financial crisis. In this decade alone we have seen a currency crisis in Europe in 1992–1993 and the Mexican crisis in 1994–1995. A number of the countries affected were suffering from major economic imbalances, which triggered currency outflows and capital flight. These crises also revealed fundamental shortcomings in the functioning of the international financial system.

In principle, access to efficient international capital markets is an advantage for a country, not a disadvantage. Norway used international capital to finance the development of its oil sector and sizeable current account deficits in the 1970s and 1980s. Norwegian enterprises have access to credit that would be very expensive in periods if we were to rely solely on domestic financing. The central government invests the capital in the Petroleum Fund in foreign markets because this is expected to generate high returns.

In the long term there is hardly any better alternative than to improve the functioning of capital markets. This is in the interest of Norway and other industrial countries, particularly countries that have a surplus of saving that must be invested abroad. This is also in the interest of many developing countries that sorely need international capital to develop their economies.

One solution that is not effective is the reimposition of direct capital controls, given the vast increase in technological capabilities to evade them. The business sector is already international. Capital controls are disadvantageous to the business sector in the countries that introduce them. Nor are taxes on capital movements or currency trading a realistic or effective alternative. Taxes will not prevent substantial short-term speculative waves. A tax system would have to have broad international support, because without it currency trading would only shift to countries without taxes. The benefit of remaining outside would increase with the number of countries that participate.

What can be done to improve a system that is functioning poorly? If a country is to benefit from a free capital market, it must draw up legislation providing for regulations and supervision that ensure stability. Countries with poorly developed capital markets may benefit from some limitations. They should exercise some caution in opening these markets too suddenly. The flow of capital is like electricity. Adequate insulation should be in place before turning it on.

When the Nordic countries liberalised credit markets in the 1980s, we experienced considerable problems because supervision and rules were not adequate. The same has been witnessed in the crisis in Asia and Russia. Inadequate and ineffective legislation and supervision resulted in weak control of financial sectors in the beleaguered countries.

The crisis is not only due to an unsuccessful policy in the countries concerned. Banks and funds in industrial countries accounted for the sharp growth in capital inflows to emerging market economies in the years prior to the crisis. Those who invested in these countries based their decisions on insufficient and, in part, misleading information. With hindsight, we may ask why so much capital was lent to countries about which lenders knew very little.

An additional problem is moral hazard: lenders may have assumed that the authorities or international organisations would bail them out if borrowers experienced payment problems. As a last resort, they may have expected the IMF to back the national authorities, which again are expected to support their banking systems. Lenders can thereby neglect to make a thorough evaluation of credit risk.

The liberalisation of the capital market *within* a country requires national regulations and supervision. The liberalisation of capital movements *across* national borders requires coordination and regulations at an international level.

Countries on the European continent have a regional approach to this. They have drawn up a set of laws and rules that govern a common European market, the single market. Norway also participates in this market by virtue of the EEA Agreement. From 1 January 1999, 11 EU countries introduced the single currency, thereby implementing one of the greatest monetary reforms of this century. Moreover, European monetary union effectively eliminates the opportunity to speculate between countries' currencies, thereby enhancing the stability of the financial system in Europe.

International rules for economic relations with other countries are important, particularly for small countries. Cooperation within the framework of the WTO and GATT agreement on trade in goods and services is an example. The OECD Capital Code, which provides a framework for member countries' laws and regulations on capital movements, is another example.

Initiatives have been taken by both the International Monetary Fund and the Bank for International Settlements to create a new international regulatory framework and system. This work is aimed at reducing the risk and effects of severe financial crises, and is so far-reaching that it has also been referred to as a new 'architecture' for the global financial system. Norway should support these endeavours.

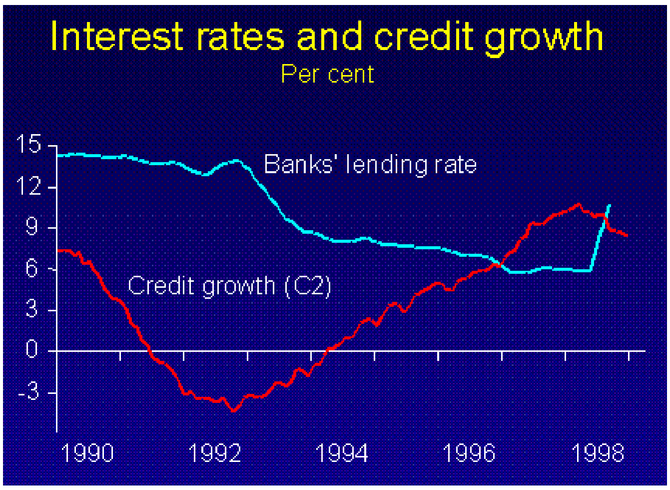
First, the new architecture must improve surveillance systems and promote greater openness and transparency in the finances and practices of government and enterprises. Necessary measures include more uniform accounting procedures and the development of international statistical standards. More modern company, bankruptcy and securities legislation must be drawn up in many emerging market economies. Second, private investors must to a greater extent bear the costs of their ill-advised investments. The IMF must impose requirements on banks in industrial countries so that they contribute to resolving the crisis they have contributed to creating. This will deter banks from assuming excessive risk. Third, supervision of the financial sector must be tightened. Capital requirements that are more closely linked to financial institutions' exposure to risk are among the measures under consideration. In addition, it is important to enhance crisis management systems because, irrespective of what we do on the preventive level, we will probably never be able to eradicate financial bubbles that escalate into financial crises.

The work on a new international financial architecture is a demanding and long-term process. This work nevertheless offers hope of achieving international agreement on some effective measures. Over time, it should also reduce the risk of local and regional crises and their contagion effect on the rest of the world.

There is still a long way to go. As far as Norway is concerned, we must act on the assumption that we will continue to live in an unstable world. The financial crises have shown that a small country is vulnerable to international turbulence. The Norwegian economy is fragile and vulnerable.

Stability and buffer against financial shocks

Norway has also experienced a banking crisis. If nothing else, we learned from it. Laws, regulations and supervision have been tightened. Financial institutions place greater emphasis on risk management. The debt burden of households is lower than in the 1980s, and for a long period the business sector was also more cautious about incurring new debt.



Losses at Norwegian financial institutions have been low since the banking crisis. There is greater uncertainty now as the economy is approaching a turning point. The sharp growth in fixed income business has led to a substantial increase in corporate debt, which has been reflected in the high level of credit growth in recent years.

The rise in interest rates has made it more demanding for households and enterprises to service their debt in the short term, but has had a restraining effect on credit growth. If interest rates had not moved up, the business sector could have continued to build up debt for a somewhat longer period, which would hardly have promoted long-term stability. Somewhat higher losses on corporate lending are now expected, although there is hardly any imminent risk to the financial strength of the banking system.

However, there is cause for concern about the evolution of the *structure* of the Norwegian financial industry in the longer term.

The free flow of capital in Europe paves the way for structural changes in the European financial industry. These changes will be prompted by the increased use of fund-based pension systems and the ever wider application of technology in the euro area. Banks in Europe will become larger, more efficient and more competitive, and securities markets will be larger and more liquid.

Structural changes are also taking place in the financial industry in the Nordic countries. Nordic financial institutions are adjusting capacity, enhancing efficiency and realising economies of scale. The largest banks are developing their activities, with the Nordic area as their home market, by building up their branch networks or through acquisitions. Not many Norwegian financial institutions have found it profitable to participate in this process.

The government’s ownership in the banking sector was expanded as part of the solution to the Norwegian banking crisis. It was not necessary to allow ownership to be permanent. Currently, the government owns the state banks, Postbanken and more than 50% of Norway’s two largest commercial banks. The government therefore controls banks that account for about 50% of bank lending in Norway. The stake in the two largest commercial banks is to be reduced to a third.

State ownership of banks constitutes, in my opinion, a structural weakness in the Norwegian financial system.

There is a risk that the ownership function is not exercised actively enough. A lack of control on the part of active owners may give the board and management excessive influence in these banks. In the long run this could lead to less efficient operations and lower profitability. Private owners with lower capital stakes may also wield a disproportionately high level of influence if the state as owner is too passive.

The political parties widely disagree on the issue of government bank ownership. This may be a disadvantage when decisions on mergers and other structural measures are to be taken. When there is a profitable basis for growth, which requires increases in capital, the state-owned banks must pose the following question: is it possible to gain political support? They cannot merely ask: will investors find this profitable?

It is important to reach political consensus on the question of state ownership. One example of a case where the political parties reached agreement on structure and ownership in the 1980s is the petroleum sector. The oil companies have therefore enjoyed stable operating parameters over the last 15 years, although this sector is also faced with the challenge of finding new solutions in response to the sharp shifts in market conditions that we have witnessed recently. This will once again require forward-looking strategies and willingness to compromise.

The government's supervisory tasks are substantial. Confidence in the banking system in critical situations may also be contingent on the government's willingness to provide financial backing. There is a fundamental conflict between these two roles and the government's role as bank owner. People must be confident that the government does not conceal its own mistakes when intervening in the face of a crisis in the banking system should this again prove necessary. It is virtually impossible to establish such confidence if the government is also responsible for the crisis through its ownership.

State ownership in the banking industry has been maintained with a view to ensuring stable national ownership. It seems that, in practice, most comparable countries attach importance to having large financial institutions with a national anchor, but most of them avoid state ownership and the associated conflicts of interest. We should also be able to do this.

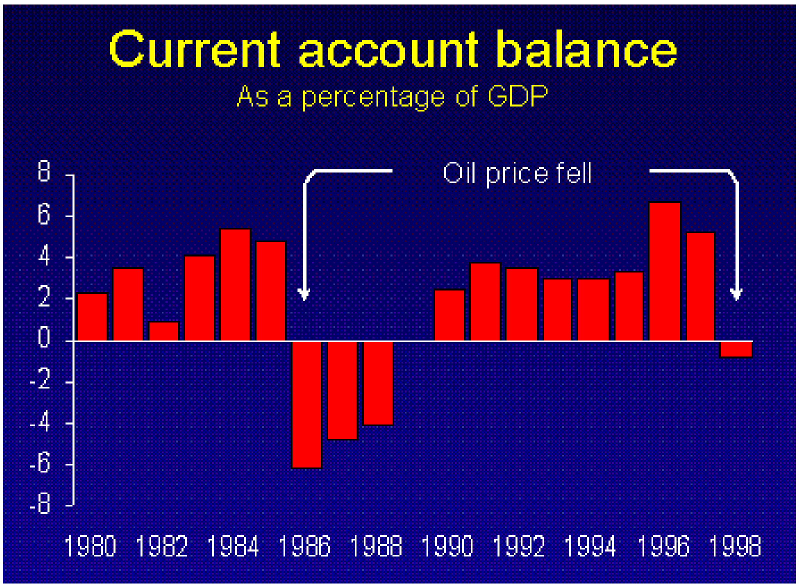
However, I would like to stress that a greater number of foreign financial institutions could also be advantageous. Foreign institutions will normally be larger and more diversified than Norwegian institutions. This could generate better and cheaper services in the Norwegian market. Moreover, these institutions might be in a stronger position to cope with a cyclical downturn in Norway or a crisis situation than banks concentrated in Norway.

At the beginning of the recession at the end of the 1980s, the Norwegian financial system plunged into a deep crisis. The debt consolidation that was necessary in the business and household sectors contributed to a sharp and prolonged downturn.

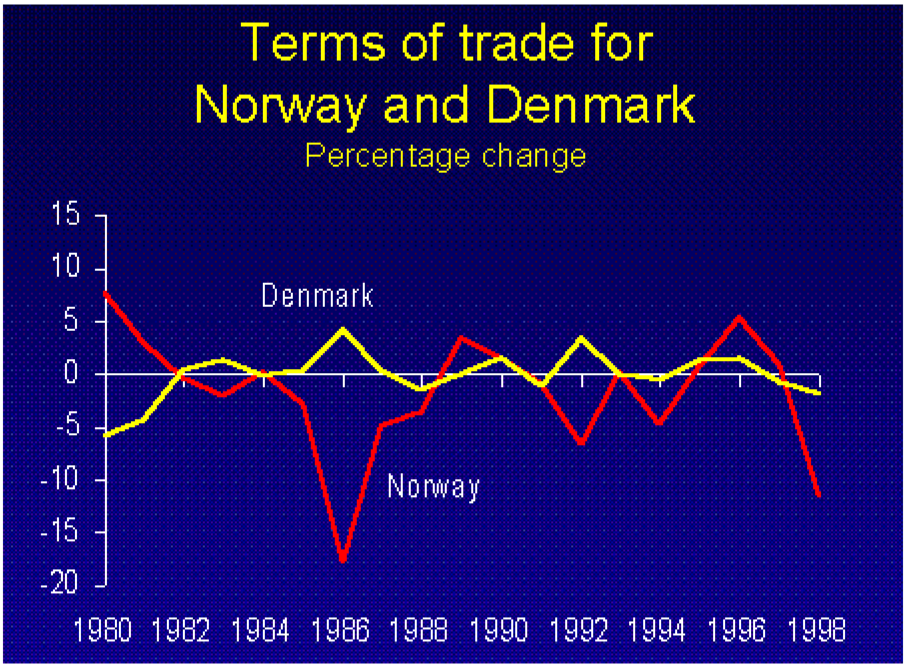
In the long term our financial system may, in my opinion, suffer in the absence of restructuring and growth capabilities. However, the overall picture is that we are better prepared this time. Households are not grappling with the same debt burden and our financial industry is in better balance.

An oil-dependent economy

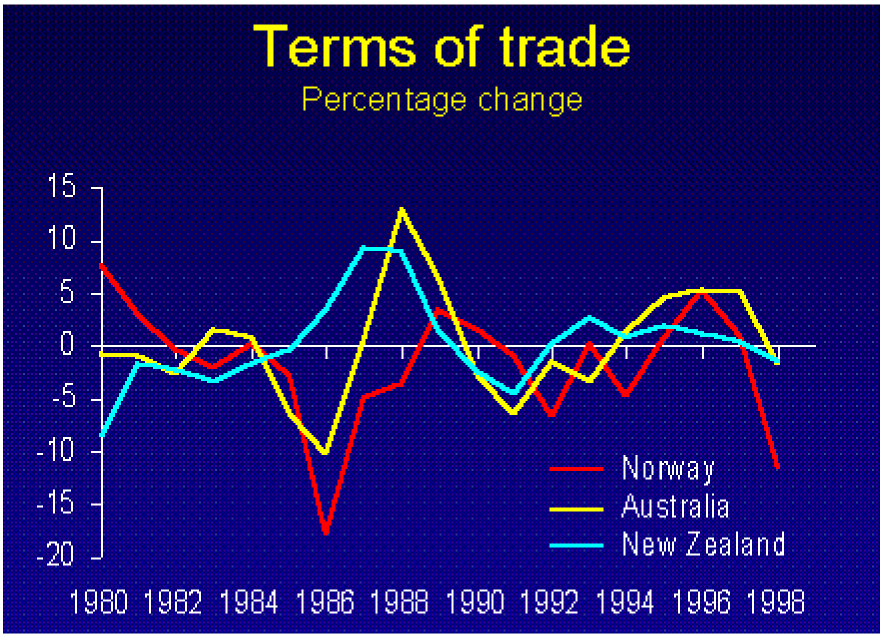
The fall in oil prices has resulted in a substantial loss of revenues in Norway. Since 1997 this has resulted in a decline in export earnings corresponding to about 5.5% of total national income. This represents the same decline in our disposable income as between 1985 and 1986, when oil prices fell by close to 50% over a few months. This time, however, the current account balance has deteriorated by a smaller margin. Growth in imports has been slower than 12 years ago. The value of non-oil exports has increased this time, while it fell in 1986. But the effect on the external account has been substantial this time as well.



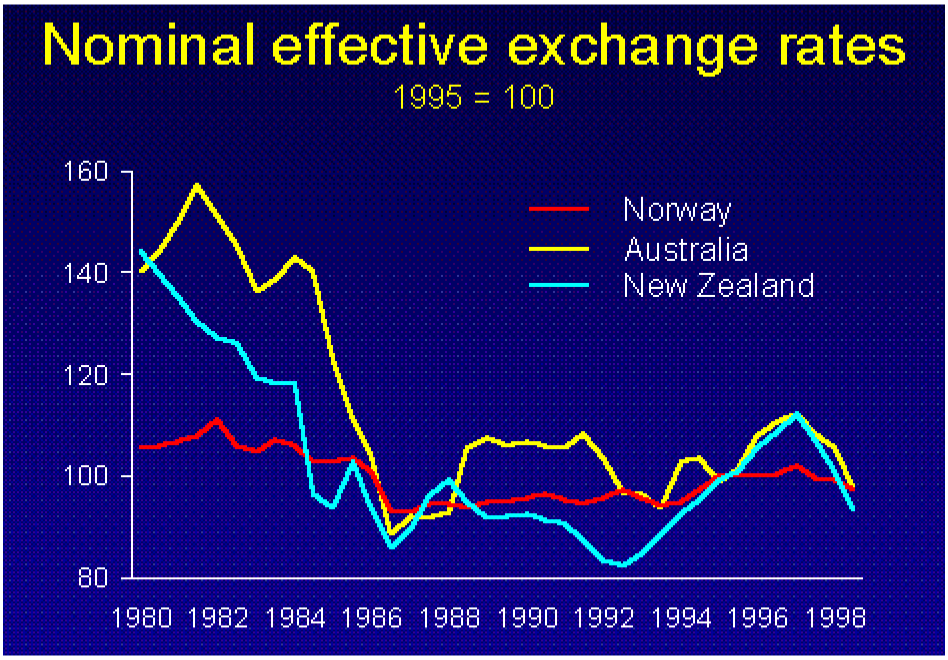
The fall in oil prices has weakened Norway's terms of trade. The terms of trade measure the price of imported goods in relation to exported goods. When oil prices decline and import prices remain steady, we must export more in order to buy the same quantity of imports.



This is not the first time that we have experienced substantial changes in our terms of trade. The most pronounced variations – in 1986 and 1998 – were due to the sharp drop in oil prices. Variations in Denmark's terms of trade are negligible compared with Norway.



In this sense, the Norwegian economy has more in common with countries like New Zealand and Australia, which are also large exporters of commodities. A substantial change in the terms of trade translates into considerable changes in these countries' earnings and balance of payments. Over the years this has resulted in sizeable exchange rate fluctuations.



The exchange rate is a buffer against changes in the terms of trade. While a country like Denmark has also managed to maintain a stable exchange rate, commodity-producing countries typically experience fluctuations in the exchange rate in tandem with changes in the terms of trade.

In New Zealand, Australia and many other countries, monetary policy is oriented directly towards price stability, and these countries permit short-term fluctuations in the exchange rate. This means that monetary policy bears the primary responsibility for price stability, whereas fiscal policy is to a greater extent oriented towards long-term stability in government finances.

Norway has established the Government Petroleum Fund in order to promote long-term stability in government finances and ensure fiscal leeway in the long term. The Government Petroleum Fund also acts as a buffer against fluctuations in petroleum revenues. Swings in oil prices lead to changes in allocations to the Fund. As a large share of petroleum revenues accrues to the state, smaller variations in these revenues will only have a limited effect on the wider economy. This makes the Norwegian economy more robust and in the short term less dependent on oil, at least as long as the government budget is running a substantial surplus. This is part of the reason why Norway seeks to maintain exchange rate stability rather than orienting monetary policy directly towards the objective of price stability.

Many countries are struggling with government finances. After several years of large government budget deficits, interest expenditure is laying claim to a considerable portion of tax revenues and thereby limiting the government's scope for carrying out its tasks. The main challenge to fiscal policy is to eliminate these deficits and reduce government debt and interest expenditure.

Norway has had greater fiscal scope for manoeuvre, although this has not solely been used to promote long-term balance. Therefore, Norway established a different division of responsibility in economic policy. As the objective of monetary policy is to maintain a stable exchange rate, fiscal policy has an important responsibility for stabilising the economy.

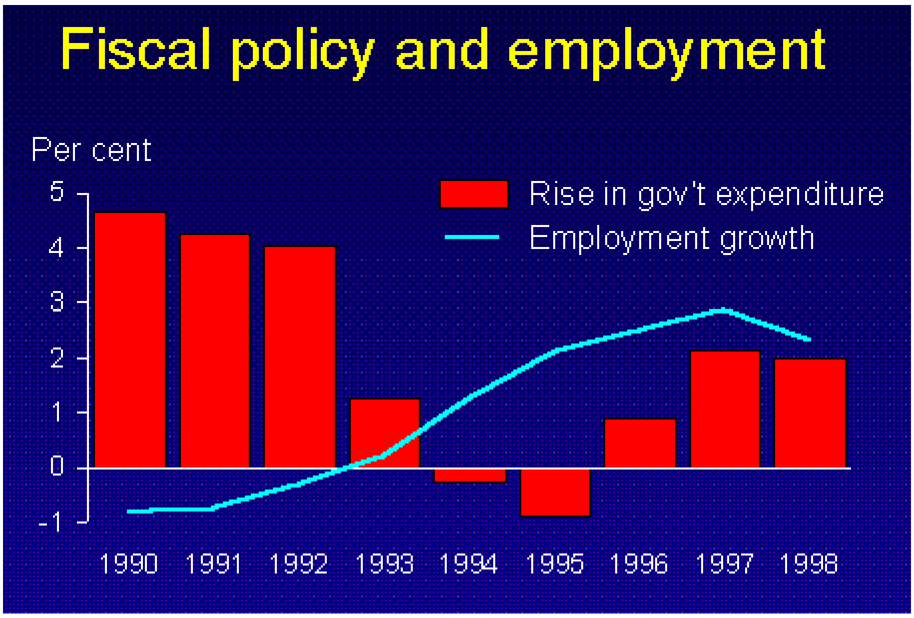
Division of responsibility fails

Stabilisation policy is a very demanding task in an economy like Norway, with occasional major exogenous shocks. The question that must now be asked is how our system functions when exposed to pressure.

Oil prices were high in 1996, 1997 and into 1998, which resulted in large surpluses on the current account and the government budget. Domestic activity was also rising, with strong growth in employment. Deliveries to the petroleum sector generated a strong and uncontrolled growth impetus to the mainland economy. During the budget deliberations in the Storting (Norwegian parliament), major changes were made. Compared with the large surpluses generated by petroleum revenues, the changes to the budget may have seemed small, but these changes were important for economic developments.

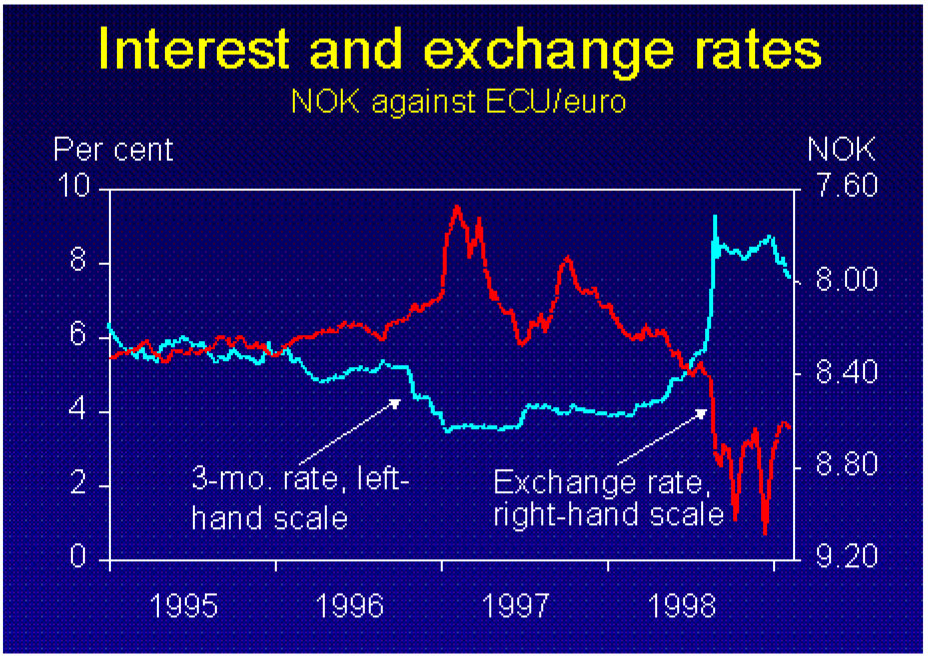
I will illustrate this by means of an example. Assume that the oil price temporarily increases by NOK 10 per barrel, or a little less than USD 1.50 per barrel. This is a small change in the oil price, well within normal variations from one year to the next. Government revenues – and thereby the budget surplus – would then increase by about NOK 9 billion in the first year and NOK 11–12 billion the next year. This corresponds to about 1% of Norway’s GDP. The assumption is that all the revenues from such a minor increase in oil prices will be transferred to the Government Petroleum Fund and that fiscal policy will remain firm. In this case, the additional revenues will not influence the economy, but be invested abroad via the Government Petroleum Fund.

On the other hand, if the additional revenues are absorbed in the domestic economy through increased government budget expenditure, total domestic demand is influenced. Increased expenditure requires an increase in the public sector’s use of resources, primarily labour. In this case, 1% of GDP is substantial. If such an increase in oil revenues is used domestically, it corresponds, for example, to around half of average annual growth in the economy. If the private sector of the economy also expands while the economy is nearing capacity limits, such a policy will heighten the pressures on resources in the economy, which in turn fuels inflationary pressures.



Unfortunately there was a clear tendency of such a policy in 1996, 1997 and 1998. The non-oil government budget deficit was indeed reduced, but the division of responsibility in economic policy required a more active tightening. Rather than conducting a tight policy and countering the higher growth in the business sector, the increase in budget expenditure entailed that the public sector also contributed to fuelling pressures in the labour market. As a result, a small change in oil prices had the effect it was not intended to have: it was accompanied by an increase in public sector demand.

Foreign exchange market participants observed that economic policy was not oriented towards containing pressures in the labour market. In a different situation such a policy could have undermined confidence, leading to a depreciation of the krone and higher interest rates. Owing to high oil prices, however, the krone was very strong in 1996 and 1997. It may be that the foreign exchange market accepted that Norway was in a situation – with large government budget and current account surpluses – where the country both could and should have transferred resources from the business sector to the public sector. It could be that market participants believed that this transfer of resources would occur with the help of a strong krone exchange rate, which reduces profitability in the business sector.



Appreciation pressures mounted and culminated in a reduction in interest rates by Norges Bank in January 1997 in order to counter the sharp strengthening of the krone.

If the central bank had not acted, the krone might have appreciated by an even greater margin. This could have given a strong signal to the business sector to move out of Norway. However, in a situation where fiscal policy was not sufficiently tight, the reduction in interest rates increased the risk of an acceleration in price and cost inflation.

Then came the fall in oil prices, with an associated erosion of the external account. Income growth for liberal professions had been substantial, wage growth for salaried employees accelerated and the wage and income settlement in 1998 was very generous. This eliminated the basis for the strong krone. In late summer the international financial crisis escalated and the krone depreciated.

High wage growth cannot be attributed to flaws in wage and income determination. On the contrary, the flexible wage and income system can probably be cited as the main factor behind the high level of employment and low unemployment in Norway. In periods of strong labour market pressures, particularly in 1974–1976, 1986–1987 and last year, wage growth accelerates sharply. Such periods are normally followed by a slacker labour market and higher unemployment. The positive feature of income determination in Norway has been that wage growth returns to normal relatively quickly, which has allowed Norway to avoid the persistently high levels of unemployment experienced by most West European countries. Even though some increase in unemployment must be expected, we should be able to avoid a rise in unemployment to European levels or to the level prevailing in the period 1989–1992 if wage and cost inflation is rapidly reduced also during this business cycle.

Fiscal policy failed in 1996, 1997 and 1998. Developments illustrate that budget discipline must be exercised down to the last billion.

The economy overheated because fiscal policy was not sufficiently tight when the economy was faring well. This brought the krone under pressure and external conditions intensified this pressure, making it impossible to keep the krone on track. It is only this year that fiscal policy is again well adapted to the economic situation.

If fiscal policy is systematically too expansionary during booms and when petroleum revenues are higher than expected, Norway will in periods experience pressures in the economy and rising price and cost inflation. This will often give rise to situations where the krone depreciates, thereby undermining the credibility of our monetary policy. There is a price to be paid for this. Market participants will lose confidence in the krone and demand a higher interest rate for maintaining krone positions rather than switching to other currencies. The result is a permanently higher interest rate level in Norway compared with other countries.

Intricate relationships

Earlier, monetary policy was based on extensive use of interventions – in other words, purchases and sales of foreign exchange in order to defend the krone exchange rate. Denmark has used this instrument with positive results. There are probably many reasons for this in addition to its stable terms of trade. For instance, fiscal policy in Denmark has on numerous occasions made a substantial contribution to exchange rate stability.

Over time our experience of large-scale and persistent interventions has been mixed. When the central bank intervenes heavily to defend the krone, market participants may easily move into a game situation and perceive central bank intervention as an interesting opportunity to make a profit. Market operators know that a situation in which the krone is being propped up only because Norges Bank is buying kroner cannot continue. It is then tempting to take reverse positions in the foreign exchange market in relation to the central bank. This means that heavy and prolonged interventions may intensify the pressure on the krone over time, steadily increasing the necessary volume of intervention purchases. The foremost example of such a game situation in Norway’s exchange rate policy history was Friday 20 November 1992, when Norges Bank made intervention purchases for NOK 37 billion from the time the market opened until the time it closed. Intervention purchases amounting to NOK 14 billion were also made the previous day after Sweden allowed its currency to float. Norges Bank had thereby depleted its foreign exchange reserves by more than NOK 50 billion in the course of six trading hours over two days.

Norges Bank does not want to intervene in such a way that this type of game situation arises. Nor can we expect other central banks to help us to an extent that makes a decisive contribution to our resistance. However, the Bank may use interventions to a limited extent if the krone moves substantially out of line with what we consider to be reasonable based on fundamentals or in the event of exceptional short-term volatility in thin markets. In such situations, we must assume that the risk of ending up in a game situation against exchange market players is marginal.

The instrument available to Norges Bank for influencing economic fundamentals is the interest rate. If the exchange rate comes under pressure, Norges Bank can counter this over time by adjusting interest rates. However, we must take into account that in the long run the krone exchange rate cannot deviate substantially from the level implied by economic fundamentals. We must therefore to some extent expect a change in the krone exchange rate in response to major changes in our terms of trade.

Norges Bank's mandate has been formulated in the light of the experience of a fixed exchange rate policy earlier in the 1990s. This experience does *not* imply that the central bank is to conduct a traditional fixed exchange rate regime, with established fluctuation margins and the obligation to intervene, as reflected in the mandate. Norges Bank will orient monetary policy 'towards maintaining a stable krone exchange rate against European currencies'. However, it is taken into account that the krone exchange rate will vary. The Exchange Rate Regulation therefore states that 'in the event of significant changes in the exchange rate, monetary policy instruments shall be oriented with a view to returning the exchange rate over time to its initial range'.

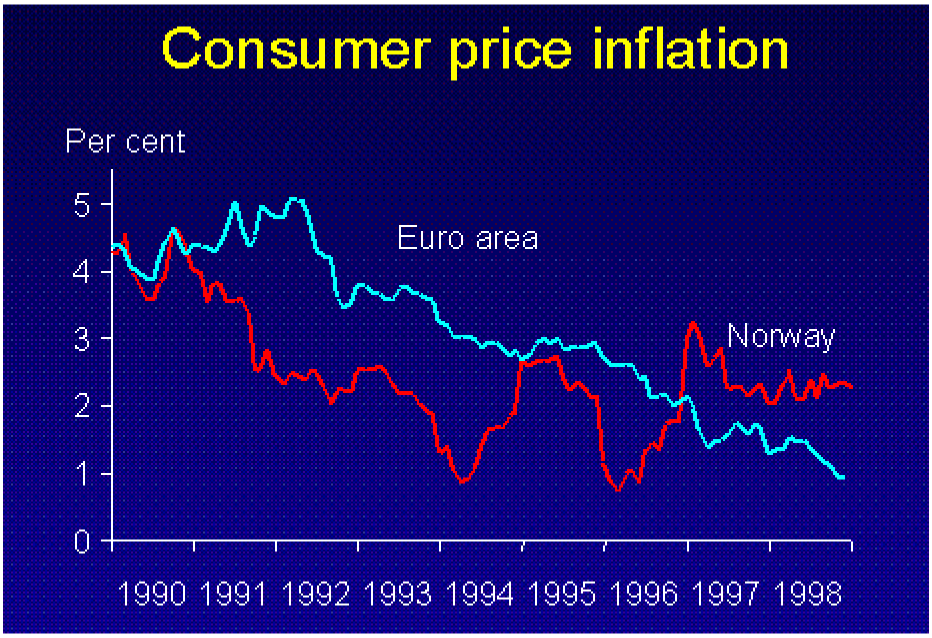
We must learn from the situation that arose in the autumn of 1996 and winter of 1997 when strong *appreciation* pressures prompted Norges Bank to reduce its key rates.

Norges Bank's first response to such appreciation pressures is to provide advice concerning changes in the budget.

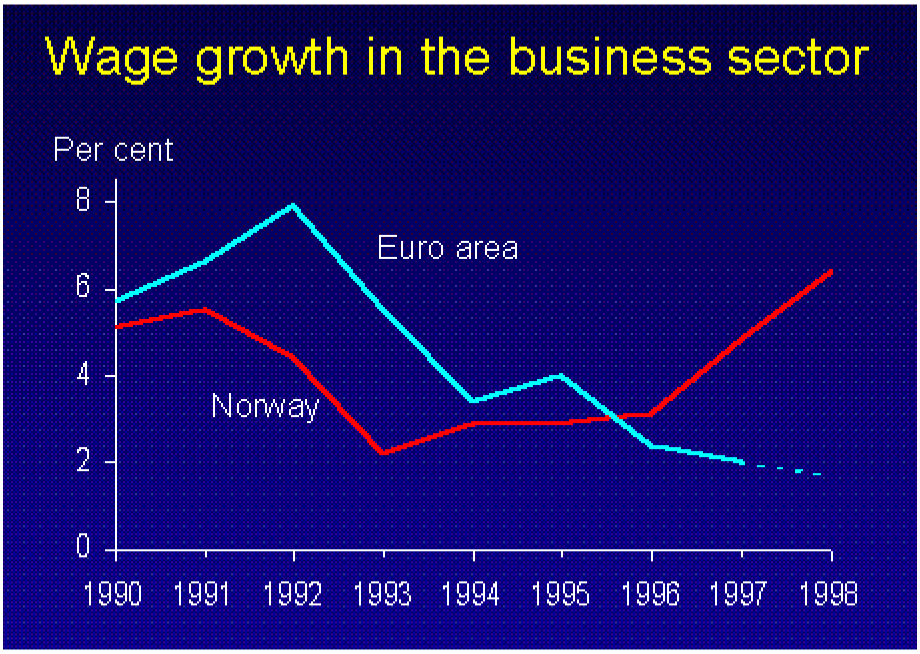
Norges Bank will orient its instruments towards maintaining a stable krone exchange rate. We must not allow ourselves to be blinded by daily exchange rate quotations. The experience of recent years shows that Norges Bank must take into account the fundamental conditions for exchange rate stability over time.

The krone is influenced by unrest in international financial markets, changes in oil prices, inappropriate fiscal policy responses and high cost increases peculiar to Norway. Norges Bank cannot fine-tune exchange rate movements through exchange market interventions. This means that the krone exchange rate will fluctuate. It is up to Norges Bank to evaluate the best means of returning the krone to its initial range. This also means that the Bank must exercise a large degree of discretion when using the Bank's instruments, essentially the interest rate. In exercising its discretion, Norges Bank emphasises the fundamental conditions for exchange rate stability.

There are two fundamental conditions necessary for achieving stability against European currencies.



First, price and cost inflation must fall to the level aimed at by euro area countries. A high rise in prices and costs will in itself fuel depreciation expectations. Monetary policy must therefore be oriented with a view to bringing price and cost inflation in Norway down to the inflation target in Europe. As illustrated in the chart, price inflation in Norway has been about 1% higher than in euro area countries over the last two years. Wage growth differentials are even wider. In this situation, pressures in the economy require a relatively tight monetary policy, as is the case today.



Second, interest rates must not be set at such high levels that monetary policy contributes to economic downturns that undermine confidence in the krone. If unemployment rises sharply, market operators may perceive the exchange rate as being overvalued and that employment can be boosted by improving business sector competitiveness. This would tend to fuel depreciation expectations. A tightening of monetary policy in such a situation would not be credible, and might trigger renewed speculation against the krone. This mechanism came into evidence during the currency crisis in the autumn of 1992.

When both fiscal policy and monetary policy are oriented with a view to influencing the domestic economy, it is important that the two components of economic policy are complementary. However, there is a risk that a situation may arise where Norges Bank maintains a high interest rate level based on its evaluation of the economic outlook, while the government authorities increase spending in order to stimulate employment. This is a genuine dilemma.

In view of its mandate and responsibilities, the best way for Norges Bank to address this challenge is probably to promote transparency in its analyses and reaction patterns so that the government authorities can take into account the implications for Norges Bank's setting of interest rates when decisions concerning the government budget are taken. The objective of monetary policy and Norges Bank's remit are drawn up by the political authorities.

For monetary policy to be successful, it is vital that fiscal policy plays an effective role.

In the short term monetary policy can influence developments in the real economy. Norges Bank can do this through two channels. First, Norges Bank will proceed gradually when the krone's value moves outside the initial range and instruments are oriented to returning it to this range. We seek to avoid a situation whereby monetary policy contributes to abrupt shifts in the economy. Second, developments in the labour market and product markets influence wage growth and inflation, and thereby the krone exchange rate. Norges Bank takes this into account when evaluating economic developments and when setting interest rates.

However, monetary policy is not a suitable instrument for influencing production and employment in the long term. Nor can it be used to influence the size of the internationally exposed sector over time. It is primarily wage and income determination, the use of oil revenues over the government budget, and the adaptability and efficiency of the economy that determines this.

Nor is monetary policy an effective tool of incomes policy. Interest rates cannot be used to influence the negotiating climate of the income settlements. This could act as a highly negative constraint on the freedom of manoeuvre.

Long-term fiscal policy challenges

The fall in oil prices has obvious and immediate implications for monetary policy. But what about long-term balance in the Norwegian economy? What if oil revenues remain low in the longer term as well?

Norway’s government finances are sound thanks to the large surpluses of recent years. A country normally seeks to achieve balanced public sector budgets over the business cycle. Norway is in a special situation, however, because of its petroleum activities. Revenues fluctuate sharply in pace with the oil price and domestic business cycles. Oil and gas production will peak a few years into the next century. It is therefore important to achieve a substantial surplus now, and accumulate financial wealth that can be used to finance the welfare system when oil revenues taper off. Otherwise, welfare schemes may have to be scaled back considerably when these revenues fall.

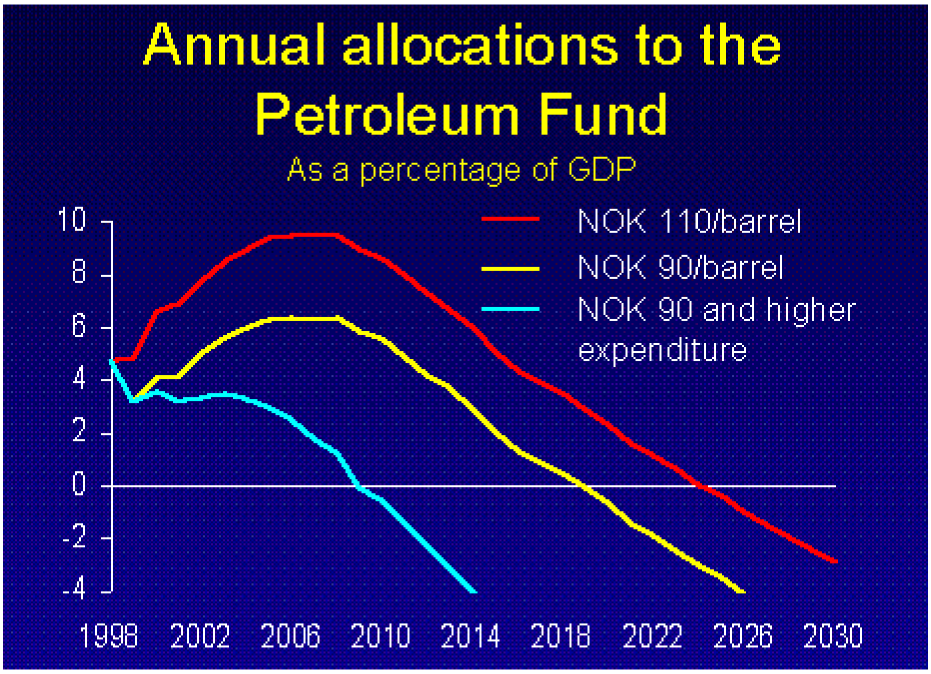
The Petroleum Fund consists of the accumulated surpluses of government finances. Capital was first allocated to the Fund in 1995. At the end of 1998 the market value of the Fund’s capital was approximately NOK 170 billion.

National insurance scheme expenditure will increase in the future. In 1999 expenditure on retirement and disability pensions is expected to amount to NOK 91 billion. This corresponds to about 8% of Norway’s GDP. The percentage will probably double over the next 30 years, and this will happen after Norwegian oil production has peaked. The challenge to the real economy is that the working population will decline sharply, while the proportion receiving income from the public sector will rise.

Projections for government oil revenues have been based on an oil price in the order of NOK 100 to NOK 120 per barrel. This will generate substantial government surpluses in the years ahead, and a seemingly steady accumulation of capital in the Petroleum Fund. The 1999 national budget estimates that in 20 years the central government’s net wealth will have risen to 120–130% of GDP. Financially, the state will thus be well equipped to cope with the higher expenditure associated with an ageing population.

So far this year, the oil price has averaged slightly more than NOK 80 per barrel. The chart shows allocations to the Petroleum Fund with oil prices of NOK 110 and NOK 90 per barrel in the years ahead. An oil price of NOK 90 will alone result in a substantially smaller surplus than previously anticipated. In this scenario, the Petroleum Fund will peak at 75% of GDP in 2015.

The bottom line in the chart shows a different scenario. We are still assuming an oil price of NOK 90 per barrel – in other words, one that is not especially low under present circumstances. In addition, we have assumed a further reduction in the budget surplus, equivalent to 0.5% of GDP, each year for the next 10 years. The combined effect is that after 10 years the budget surplus will have declined by about 5% of GDP compared with the other calculations.



This may seem substantial, but is no greater than the changes in the budget balance that we have seen previously. In the previous downturn, the government reduced its surplus by slightly *more* than 5% by means of an active countercyclical policy – and that was only during a five-year period. The tightening so far in the 1990s has been of roughly the same magnitude. By contrast, we are now looking at a permanent change in the government surplus.

This scenario is not entirely improbable. A pause in growth lies ahead for the Norwegian economy, and we must expect some increase in unemployment. This will quickly translate into demands for expanded public sector activity. The government has some room for manoeuvre to address this challenge by boosting public expenditure or cutting taxes.

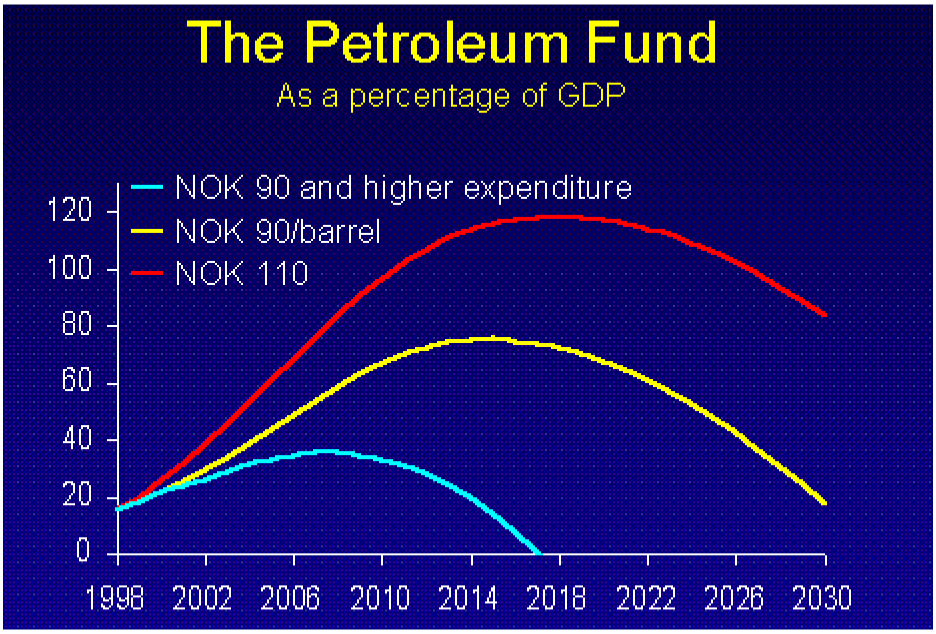
However, our calculations show that in the course of a few years an expansionary fiscal policy could lead to a substantial reduction in the government's scope for manoeuvre.

What I want to demonstrate is that pursuing such a policy now – assuming that the oil price remains low – would have a major impact on the ability of the government to finance the welfare society. As we see, it would not result in any increase in the budget surplus in the next few years. On the contrary, the surplus would gradually be reduced, and in about 10 years the budget would begin to show a deficit.

The Petroleum Fund would suffer a sad fate and would be depleted in 18 years.

This is just an illustration, however. Developments would compel a shift in fiscal policy long before the Petroleum Fund is depleted. But *that* in turn would mean that the state would not have the scope for manoeuvre to stimulate total employment. It would not be easy to reduce the central government deficit in a situation with declining oil revenues.

We might, of course, be fortunate enough to experience a rise in oil prices again, so that we do not have to deal with this problem. Perhaps the oil price is abnormally low at present. But it is important to be aware that the government, in expanding welfare programmes and public sector activities, has not taken due account of the possibility that oil prices will remain low over a longer period.



We have already witnessed a depreciation of the krone in response to the deterioration in Norway's terms of trade. This may reflect expectations of continued low oil prices and lower revenues in the long term. This also compromises confidence in the government's long-term financial position. It is risky to increase expenditure and reduce taxes when there is doubt regarding the long-term balance of the economy. An expansionary fiscal policy could increase uncertainty and the fluctuations in the exchange rate, and reduce Norges Bank's freedom of manoeuvre. On the contrary, fiscal policy should be oriented to provide room for lower interest rates that can counter a cyclical downturn in an environment of stable wage and price inflation.

The authorities must be very cautious about further embedding fixed long-term priorities in the central government budget. If oil prices remain low, it may quickly become necessary to take a critical look at the scale of welfare schemes and public sector services, and it may also be necessary to increase taxes. If, later in the business cycle, measures are called for to curb unemployment, they should be designed to be readily reversible and in such a way that they do not erode government finances in the long term.

Conclusion

By way of introduction, I posed the following question: is our economy sufficiently robust to cope with the fall in oil prices without a new round of major structural adjustments?

Our financial system is in a stronger position to cope with a new downturn than it was in the 1980s. We have avoided a debt bubble of the scale we witnessed last time. However, I am in doubt as to the financial industry's long-term restructuring capacity.

Norway must endorse the development of a new architecture for the global financial system. This is a demanding and long-term process, and we cannot expect all the problems to be solved over night. On the other hand, if we are to have any hope of a more stable and predictable world economy, the only real alternative is to enhance international codes for financial markets.

We have observed that confidence in the krone is fragile. In order to restore confidence and maintain a stable exchange rate, monetary policy must be a credible anchor for expectations of continued low price inflation. Monetary and fiscal policy must be complementary in order to curb cyclical fluctuations.

Fiscal policy must be credible in the long term. The welfare society is dependent on solid government finances. The authorities must exercise caution in establishing fixed long-term priorities in the government budget. Measures aimed at countering an increase in unemployment must not be irreversible and undermine long-term credibility.

The conditions for addressing the challenges are favourable. Employment is high and the population is well educated. However, our economy is also exposed and vulnerable.

In recent years fiscal policy has been too expansionary. This year the fiscal stance is appropriate. A continued tight fiscal policy can contribute to restoring credibility and confidence so that interest rates can gradually be reduced. Let this be my hope for future developments.