Svein Gjedrem: Monetary policy, securities markets and municipalities

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the anniversary seminar, Kommunalbanken, 30 August 2002.

Please note that the text below may differ slightly from the actual presentation

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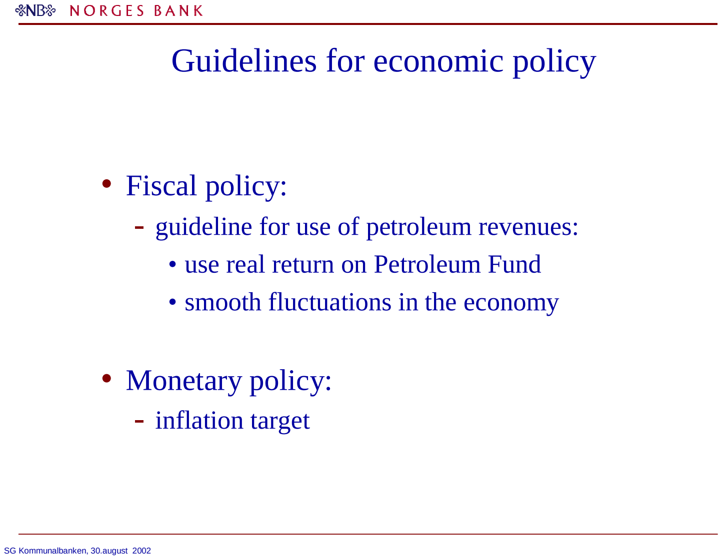
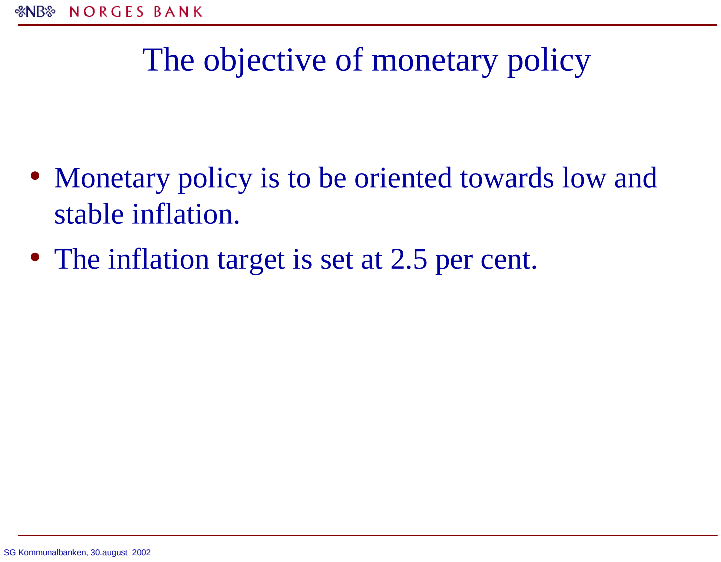
In my address today I will touch on three themes. First, I will discuss monetary policy and its influence on municipalities' financial position, followed by some remarks on the Norwegian bond market and Kommunalbanken AS. I will then conclude with some reflections on the challenges associated with the pension system and the interplay with securities markets.

Municipalities' financial position and monetary policy



Norway's economic policy is based on the guidelines for fiscal and monetary policy. The guideline for fiscal policy states that the use of petroleum revenues over the central government budget shall be equivalent to the expected real return on the Government Petroleum Fund. Most of the phasing in of petroleum revenues will take place over the next ten years. With a 4 per cent return on the Petroleum Fund, the use of petroleum revenues will rise to almost 5 per cent of mainland GDP in 2010.



Monetary policy is oriented towards low and stable inflation. The inflation target is set at 2½ per cent. When monetary policy is geared towards stabilising inflation, it also contributes to stabilising demand and production. Low and stable inflation fosters stability in the economy. The inflation target is the nominal anchor for the Norwegian economy.

Low inflation is the objective, and the interest rate is the instrument. Monetary policy functions with considerable and variable lags. The current level of inflation does not provide an adequate basis for determining the level at which interest rates should be set today. Our analyses indicate that a substantial share of the effect of an interest rate change will occur within two years. Two years is therefore a reasonable time horizon for attaining the inflation target.

Economic agents can act on the assumption that the inflation rate will be close to 2½ per cent over time. If it appears that inflation, with unchanged interest rates, will be higher than 2½ per cent, the interest rate will be increased. If it appears that inflation, with unchanged interest rates, will be lower than 2½ per cent, the interest rate will be reduced. There is symmetry here. It is just as important to avoid a rate of inflation that is too low as it is to avoid a rate that is too high.

Changes in labour costs influence the rise in prices for domestically produced goods and services. Labour market tightness is heavily influenced by demand for goods and services. High levels of private and public consumption, investment and exports will sustain the demand for labour. When the supply of labour is limited, competition for labour pushes up wages.

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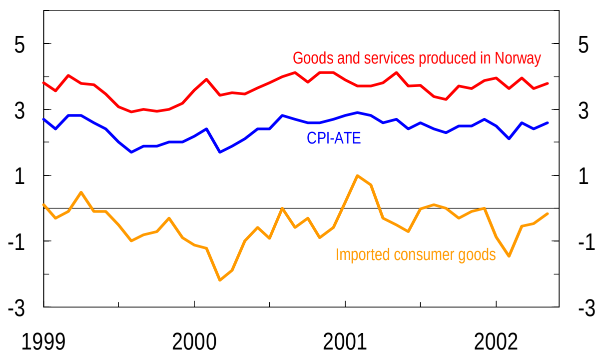
Low imported price inflation pushes down consumer price inflation. Price inflation by origin. Per cent



Sources: Statistics Norway and Norges Bank

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In many countries, low and stable inflation is the goal of monetary policy. It can therefore be assumed that imported inflation will remain subdued. But, the rise in prices will still vary as a result of global economic developments. The krone exchange rate also plays an important role in determining import prices. A strong krone will curb prices for imported goods. When there is a rise in interest rates in Norway and a widening differential between domestic and foreign interest rates, investments in NOK increase, and the krone exchange rate appreciates.

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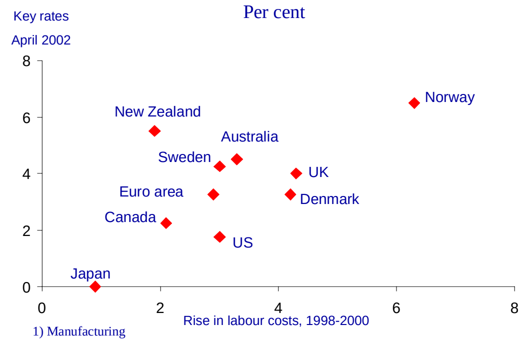
Key rates and rise in labour costs[1)]
Per cent



1) Manufacturing

Sources: OECD and Norges Bank

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Interest rates are higher in Norway than in most other OECD countries. This is a direct result of the markedly higher level of nominal wage growth in Norway. Wage growth has ranged between 5 and 7 per cent every year since 1998. This year's wage settlement appears to be following suit. Strong wage growth is the result of a tight labour market.

Wage increases in this year's settlements were high. Wage settlements in the internationally exposed sector did not set the trend for wages. Wage growth in several sheltered sectors, including the local government sector, is likely to be considerably higher. This is a break with the pattern observed a few years ago.

The phasing in of petroleum revenues increases demand for labour in the public sector and in enterprises selling goods and services to households. The contest for labour is reflected in high wage growth and a deterioration in competitiveness in exposed industries.

Many enterprises in the sheltered sector can, in principle, pass on higher labour costs to customers. Monetary policy must reduce the possibility of passing on these costs in order to keep inflation at bay. This is done partly by keeping growth in demand for goods and services under control. In addition, a strong krone may boost imports of goods and services previously reserved for domestic producers.

In rural areas and towns, where local government employment is an alternative to working in agriculture, fisheries, local services or small-scale industry, the public sector with its nationwide agreements can be a wage trend-setter. Wage growth in the public sector can therefore be an important source of higher inflation.

In the public sector, higher labour costs due to costly income settlements can only be passed on to customers to a limited extent. On the other hand, the rise in costs can intensify pressures to increase government allocations. Most likely, the central government will be expected to pick up the bill when labour costs rise sharply.

In the business sector – with its profitability requirements – higher labour costs must be matched by an increase in productivity. In principle, the central government will apply the same requirements to government agencies. How these requirements will be met in practice will have a decisive impact on developments in central government expenditure and, consequently, on interest rates and the krone exchange rate.

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Real growth in public spending

Revised National Budget 2002

	2002
Growth in central government expenditure	7.0%
- Rise in prices for expenditure	4.4%
= Real spending growth	2.5%
Distributed as follows:	
Real growth, transfers	2¾%
Real growth, investment	6¾%
Real growth, consumption	1½%

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Growth in public spending between 2001 and 2002 is estimated at 7 per cent. This is considerably higher than growth in private sector mainland GDP, which is estimated at around 4 per cent. The fiscal guideline is then closely adhered to. Real growth in public consumption is estimated at 1½ per cent. In other words, growth in production of public services will be moderate, even though public spending is rising sharply in nominal krone terms. This is because the cost of producing public services is rising sharply, reflecting high wage growth in the public sector. There have also been substantial increases in transfers to the household sector through social security schemes. The bulk of the high growth in central government allocations therefore translates into strong growth in household income and consumption. This tends to be the result when wage and costs pressure are already at such a high level. If the central government were to compensate public sector entities for the high wage increases, the result could easily be a new round up the wage spiral.

The high level of interest rates and the strong krone reflect real economic driving forces, such as a high level of petroleum revenues, a tight labour market and strong growth in household income, consumption and borrowing. In addition, a shift in the wage formation process may have added to the particularly high rate of overall wage growth. If these forces are restrained, there is also hope that the pressures on monetary policy will subside.

The bond market

Market interest rate rates determine the compensation afforded to savers for abstaining from consuming today and the price the investor has to pay for borrowing the savings of other agents. The financial sector is the intermediary that channels savings to profitable investment projects and seeks to achieve optimal use of existing capital. The financial system should also enable borrowers and investors to diversify risk. Banks and securities markets ensure the distribution of capital and risk management.

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- The financial system has been subjected to shocks:
  - Cyclical downturn in the major industrial countries
  - The IT share bubble burst
  - Terror attacks in the US
  - Argentina "bankrupt”
- Confidence eroded
  - Large-scale fraudulent accounting practices by US companies

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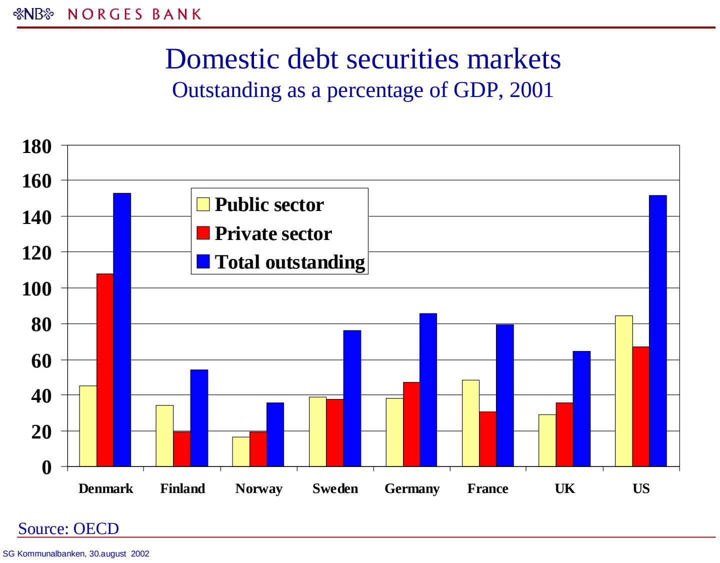
In the last few years, the financial sector has been under considerable strain. There has been a downturn in the major industrial countries, a collapse in technology stocks, terror attacks in the US and default on government debt in Argentina. Equity prices have plummeted and bond defaults have increased sharply. The scandal at the energy company Enron and the recently disclosed fraudulent accounting practices at several US companies have eroded confidence in securities markets and the financial system.

One role of securities markets is to ensure that the risk linked to various investments is reflected in borrowing costs and expected returns, which are adjusted continuously through market price mechanisms. For price mechanisms to function effectively, it is essential that there is confidence in the information and results published. The US authorities have already taken measures to prevent further accounting and audit scandals. Several initiatives are also expected to be taken internationally.

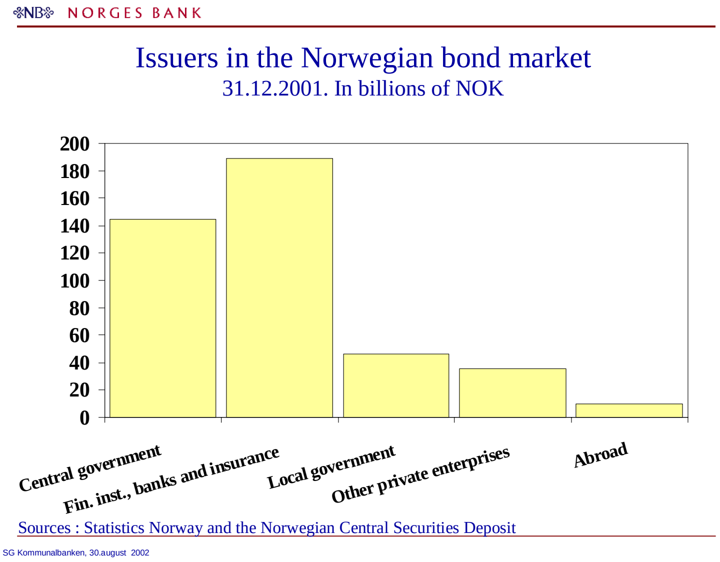
Smoothly functioning securities markets make an important contribution to a stable and efficient financial system. Without securities markets’ contribution to risk diversification, it is highly unlikely that the financial system could have coped as well as it did with the shocks of recent years.

Norway has a well developed financial system. Financial institutions such as banks, mortgage companies and insurance companies channel assets and debt between economic agents. In the securities market, capital is channelled directly from lender to borrower through the use of standardised debt and equity instruments in the primary market. Securities can also be traded in the secondary market. Substantial volumes of debt and equity instruments are traded daily among operators. The debt market consists of bonds and short-term debt instruments, while the equity market is essentially made up of stocks.



The Norwegian bond market is very small on an international scale, whether it is the government bond market or the private bond market. Corporate debt issues in Norway are more limited than in most comparable countries. The chart shows that this market is also small in a Nordic context.

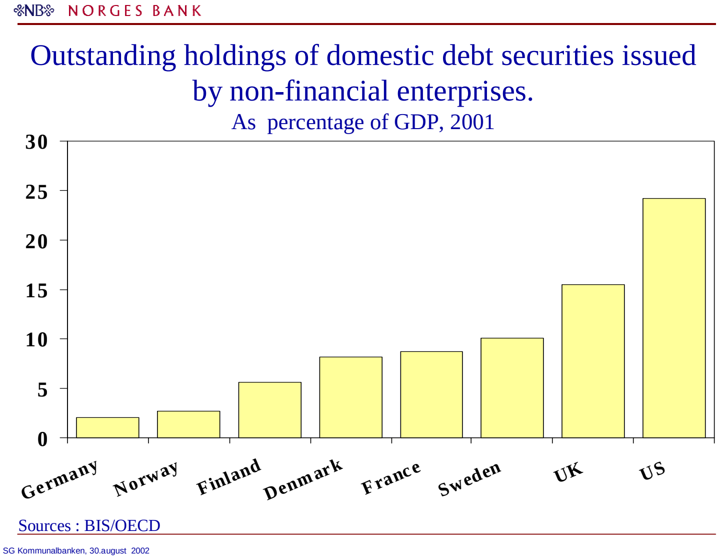
Foreign investors have recently shown a growing interest in NOK-denominated bonds as a result of strong growth in the Euro-krone market. This is the result of the relatively high level of interest rates in Norway. International operators are issuing NOK-denominated bonds on a large scale. At the same time, this provides life insurance companies and investment funds with an investment alternative in NOK.



The largest holders of Norwegian bonds are insurance companies, but the government, private companies and foreign investors also account for a large share of bond holdings. The largest issuers are the government and financial institutions.

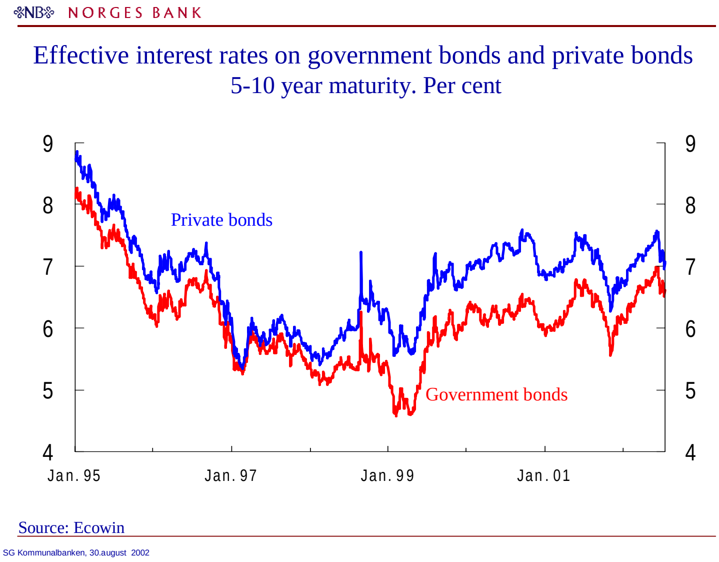
Kommunalbanken is also a fairly large issuer in the Norwegian bond market. At the end of 2001, the Bank’s total bond and commercial paper debt came to about NOK 26 billion. This accounted for a good 6 per cent of total outstanding bond and short-term debt issues in Norway at the end of last year.

There are historical reasons for the thin securities market in Norway. From the post-war period and up to the beginning of the 1980s, the Norwegian bond market was subject to direct regulation. It was only in the late 1980s that the market for bonds and short-term debt was liberalised and it is now part of the international market.



The turnover and issue volume in the market increased sharply up to the mid-1990s. However, Norwegian companies use the bond market on a far more limited scale than companies in comparable countries.

Solid state finances also help to explain the limited size of the private bond market in Norway. A well functioning government bond market can stimulate the private segment of the debt securities market. In most countries, the state has a sizeable borrowing requirement, with a high level of debt. Even though its borrowing requirement is small, the Norwegian government also places emphasis on a well functioning bond market in its government debt policy. Government debt issues are confined to few and large standardised loans. This contributes to higher turnover in the secondary market and hence greater liquidity. With ample liquidity and low risk, government bond rates can serve as a benchmark for private bonds.



The interest rate on private debt securities is heavily influenced by the interest rate on comparable government securities. Private issuers have to pay a somewhat higher interest rate than the government because they have a lower credit rating. Another factor is the liquidity of the debt instruments. The rate differential between government securities and private debt securities therefore consists of both a credit risk premium and a liquidity premium. Normally, the larger and more developed the market is, the lower the liquidity premium is. The financial position of local government in relation to the central government ensures that there is little or no credit risk linked to the bonds issued by Kommunalbanken or municipalities. Because of the liquidity premium, however, Kommunalbanken and the municipalities would benefit from a more developed and more liquid bond market in Norway.

I can find several reasons why the Norwegian economy would benefit from a larger portion of credit being channelled through the debt securities market.

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- A well developed debt securities market:
  - Enhanced risk management
  - Continuous pricing of risk reduces the possibility of shocks
  - Provides the financial system with two legs to stand on

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a) Enhanced risk management

Bonds and short-term issues are traded in the secondary market. More participants are thereby given the opportunity to invest in assets that have largely been reserved for financial institutions. Banks are also provided with increased possibilities to diversify the risk in their loan portfolios across different sectors and regions. All in all, this contributes to spreading the credit risk linked to the loans. When risk is diversified, the financial system is less vulnerable in the face of financial turbulence.

b) Continuous pricing of risk reduces the possibility of shocks

Loans from financial institutions and securities debt differ widely in terms of the degree of transparency in credit rating and pricing. The credit rating in financial institutions must be looked upon as internal company information. Loans provided by banks and financial institutions are far less liquid than negotiable securities and the price will generally not change as a result of new information about the borrower. On the other hand, securities markets are subject to transparency and information requirements. Participants' credit ratings are continuously reflected in the transparent pricing process in the market.

The stability in our financial system is strengthened when market operators' assessment of the correct value is reflected transparently and continuously in prices. A precondition is of course that the information that companies are obliged to provide is correct. Economic shocks will also be more easily absorbed, even though considerable price changes may have substantial wealth effects. Because banks lend at relatively fixed rates, financial institutions must be able to adjust volumes when new information is available. This, for example, can be done by refraining from rolling over short-term loans. The spillover effects of unexpected events may therefore be more substantial for bank loans than for securities debt.

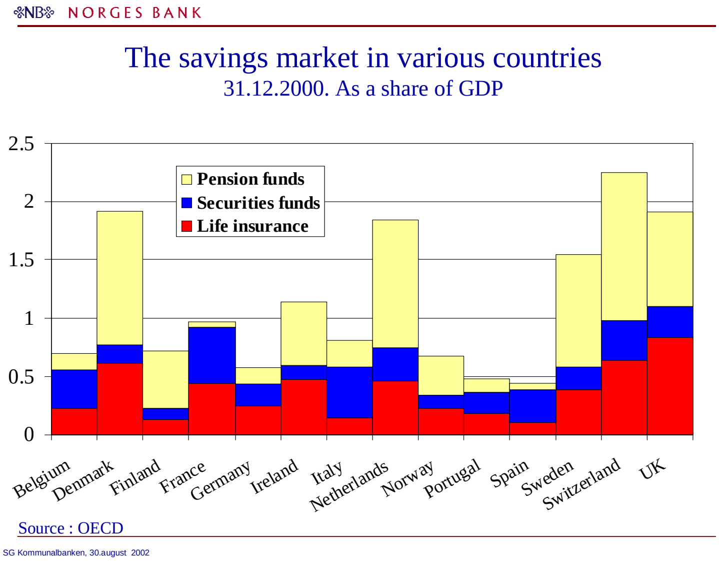
c) A well developed debt securities market provides the financial system with two legs to stand on

Financial crises are normally related to the banking system. The crises have partly been the result of a very high concentration of risk in banks. In crisis situations, we have seen that financial institutions and securities markets can be complementary and prevent a credit crunch. One example is the crisis that followed the collapse of the US hedge fund LTCM in 1998. For a period during the crisis, there were substantial problems in the private bond market in the US. Financial institutions increased lending and prevented a more extensive credit crunch. Conversely, we have seen that when there have been problems in the banking sector, securities markets have replaced bank loans.

Changes are now taking place, which I think will contribute to strengthening the Norwegian bond market. Proposed legislation changes will for example provide for the sale of housing loans to a separate entity that finances the purchase by issuing bonds.

The proposed legislative amendments would permit a wider range of issues in the bond market. In general, a larger number of issuers and investors would enhance liquidity in the secondary bond market. This could also directly or indirectly strengthen banks' position.

Funding of pensions



The organisation of the pension system in Norway will also be of considerable importance to the local government sector as a big employer. The securities market will also be influenced by the pension system Norway will have in the future. Life insurance companies and pension funds are major operators in the Norwegian securities market.

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- Design of a new pension system:
  - "Pay-as-you-go"
  - Fund-based schemes:
    - Defined contribution
    - Defined benefit
- Who should bear the risk?

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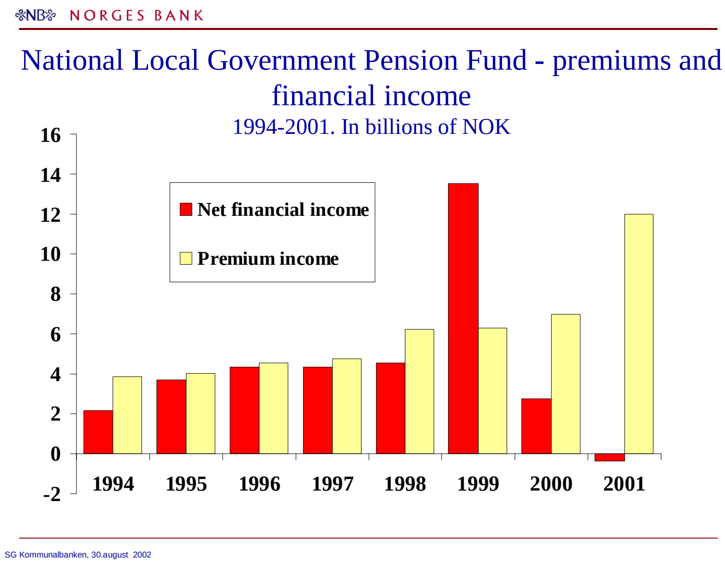
In Norway, the bulk of pensions are funded through the pay-as-you-go system. It is the taxation of current income that pays for the National Insurance Scheme's current pension benefits. For the vast majority of western countries, estimates show that substantial tax increases will be needed to cope with the ageing of the population. The alternative to the pay-as-you-go system is to build up funds prior to the payment of pensions. These funds can consist of different assets such as stocks and bonds.

More fund-based schemes will generate a positive stimulus to the Norwegian securities market, even if an appropriate risk diversification would imply that a large portion of the capital in pension funds is invested abroad. A rising share of fund-based schemes in other countries will also increase investment in Norway. The statutory regulation of pension fund investment will also be of importance. For example, today most countries have relatively stringent restrictions on the equity portion in pension funds' portfolios. However, a proposed new EU directive would make it possible to increase this portion, which may have an impact on demand for securities.

Recent developments in financial markets have shown that a substantial measure of uncertainty is associated with the return on such investments. This uncertainty is related to future economic developments, which will also apply to the pay-as-you-go system. It is true that Government can influence this through tax changes. Adverse economic developments will, however, put the ability and willingness to increase taxes in order to honour pension obligations to the test. This uncertainty will be even greater in a country like Norway that is highly reliant on one or a small number of industries. Government finances are, for example, still vulnerable in the face of a sustained decline in oil prices. The uncertainty about future developments is continuously reflected in a fund-based system.

An essential question associated with a fund-based system is who is to bear the risk related to returns. It is common to distinguish between two forms that provide different solutions for this:

A defined-benefit pension scheme is an agreement to pay a specified benefit amount irrespective of the return on the premiums paid in. The benefit can be adjusted for inflation, wages or the like. Premium payments can be changed as a result of demographic changes such as higher life expectancy, but not as a result of lower returns. A fall in returns must be covered by the company or entity if they have their own pension funds. Pensioners are secure under municipal defined-benefit based pension schemes, while municipal service production must absorb the impact of lower returns.



In recent years, municipalities have noticed this additional burden as owners of the National Local Government Pension Fund. However, high returns restrained the rise in premium income towards the end of the 1990s.

The alternative to a defined-benefit pension scheme is a defined-contribution pension scheme. The defined-contribution pension plan is a programme under which members decide how pension savings are invested. Future benefits depend on the return. It can be agreed that the pension payments are to be fixed. The size of payments will then depend on how much has been saved, the pension period and calculated return.

Under a defined-benefit pension programme, life insurance companies and pension funds – or those behind them – in a sense offer insurance against a form of absolute risk to which everyone is exposed. Absolute risk may, for example, be a change in economic developments as a result of major disturbances to the world economy or the domestic economy.

Under a defined-contribution pension scheme, the individual member assumes the absolute risk.

With a larger share of pension savings in defined-contribution schemes, some of the risk that is now being borne by insurance companies will be transferred to members. One problem that may arise in connection with defined-contribution schemes is that members end up with benefit payments that are markedly lower than expected. Therefore, it would also be appropriate to apply risk limits to defined-contribution pension schemes.

Conclusion

The local government sector employs a rising share of workers in our country, accounting for close to 25 per cent of employment today. The behaviour of local government, as a user of labour and employer, is of considerable importance for economic developments and also for the inflation outlook. The local government sector is a major user of financial service, both as borrower and as buyer of insurance products.

Norway has a well-developed financial system, but its bond market is small compared with other countries. In the long run, a larger and more liquid bond market in Norway could provide a basis for improved risk management and enhanced diversification of risk in the financial system.

A new pension system is now being considered. One of the main questions relates to the distribution between pay-as-you-go and fund-based schemes. There will always be a measure of uncertainty associated with future economic developments, and thereby with future pensions. The funding of pensions will continuously reflect this uncertainty. Not even public pay-as-you-go schemes can guard us against this. A higher proportion of fund-based schemes will make this uncertainty more visible and provide greater opportunities for each individual to adapt.

Thank you for your attention.