Svein Gjedrem: The economic outlook

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, Oslo, 8 April 2010.

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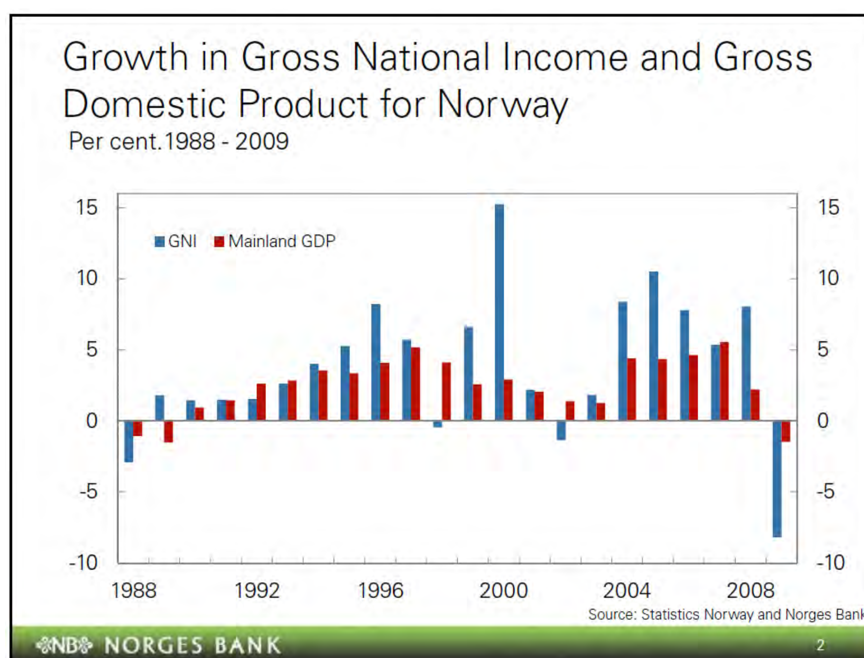
The address is based on the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 24 March, Monetary Policy Report 1/10 and previous speeches. Please note that the text below may differ slightly from the actual presentation.

Excellencies, Ladies and Gentlemen,

Since our meeting a year ago, the international economy has begun to recover from the financial crisis. Norway has weathered the crisis better than most countries. In my presentation today, I would therefore like to discuss how underlying economic forces have benefitted the Norwegian economy through two "golden decades". I will comment on the Government Pension Fund Global and how the financial crisis has influenced its investments and returns. A key lesson from the crisis has been the need for international cooperation and collective action. Before concluding, I will therefore highlight the importance of multilateral and statutory-based institutions for sound international economic governance.

The Norwegian economy – two golden decades

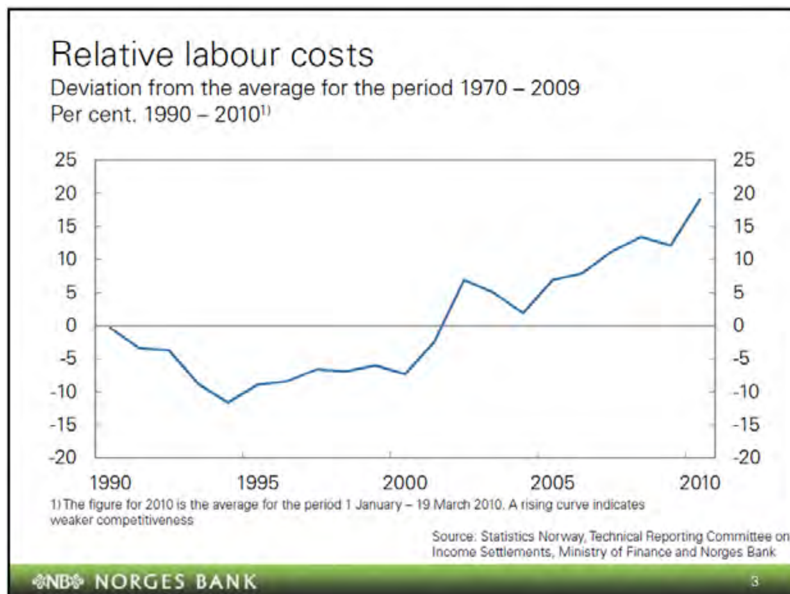
The economic downturn in Norway proved to be mild. Norway has not experienced a pronounced downturn since the crisis around 1990, when a cost crisis, an employment crisis with a sharp increase in unemployment and a decline in output, a currency crisis, a fall in property prices and a banking crisis all occurred at the same time.



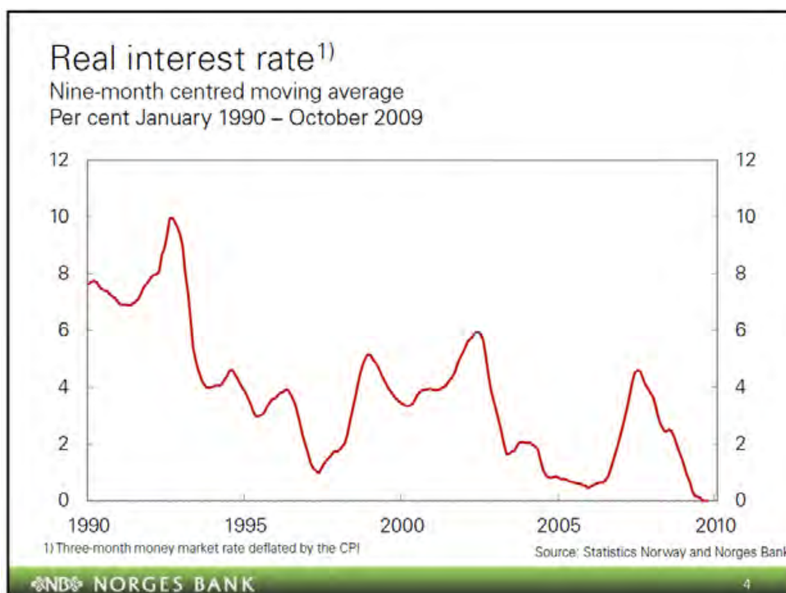
A long upturn followed from 1992 to 2008. National income rose by an annual rate of 5.4 per cent in this period, far higher than the rate of output growth in the mainland economy. Income growth was even higher than in the post-war period in the 1950s and 1960s.

Major structural reforms

Behind these favourable developments were the major structural reforms of the 1980s and 1990s that resulted in an expanded production capacity in the Norwegian economy. Capital and credit markets were liberalised. It became easier to establish and build up new businesses. The EEA and WTO agreements resulted in stronger competition and increased flows of goods and services, labour and capital. As a result of the 1992 tax reform, the welfare state could be funded with reduced impact on wealth creation. The framework conditions for the electricity market, telecom market, aviation and broadcasting were changed. Trade was liberalised. State-owned companies were listed on the stock exchange and new forms of managing public agencies were developed. Industrial policy no longer kept unprofitable enterprises afloat. Subsequently, the business sector experienced a long period of high productivity growth.

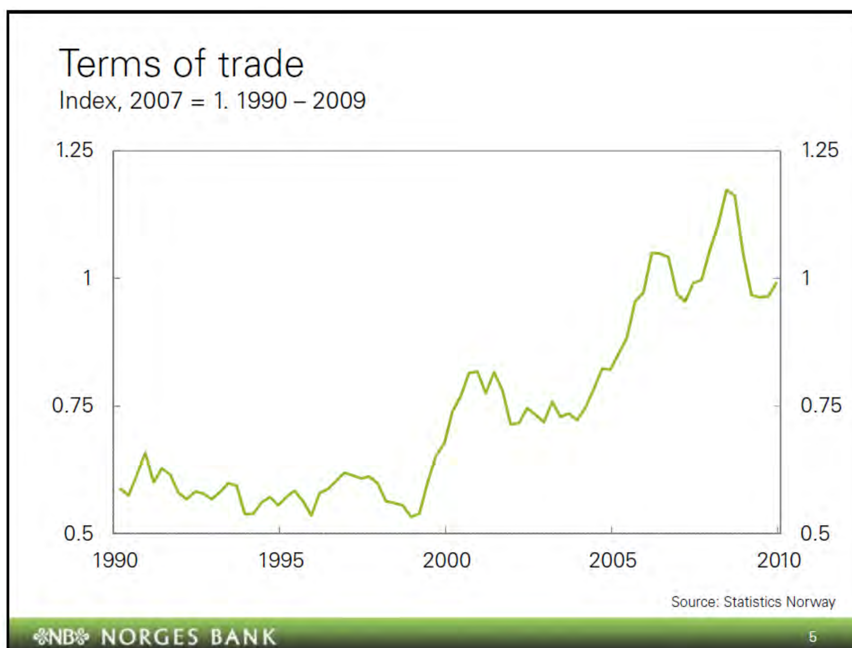


Moreover, shifting forces have driven the economy. In the wake of the crisis around 1990, labour costs decreased to a low level compared with Norway's trading partners and wage settlements were moderate. In 1995, the cost level was 10 to 12 per cent below Norway's average for the oil age from 1970 until now.



In addition, real interest rates in Norway fell markedly through the 1990s from high levels. This was because the fixed krone exchange rate regime maintained through the period managed to bring down inflation and inflation expectations.

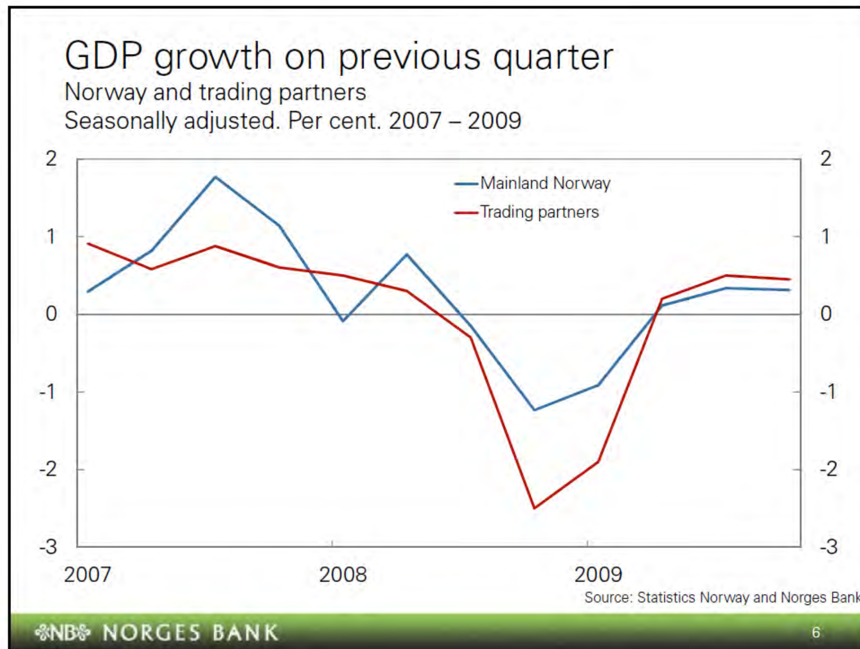
Moreover, growth in public spending was rapidly reduced once business sector activity had recovered.



Economic shift

Over the past decade Norway experienced an economic shift. The cost level began to rise. This was related to the sharp improvement in Norway's terms of trade at the time and a gradual pickup in growth abroad. Prices for Norwegian exports such as oil, gas, metals, minerals, fish and freight, rose markedly, while prices for imported goods fell. From 2003 to 2008, terms-of-trade gains alone pushed national income up by more than 20 per cent, or a good 4 per cent per year.

Institutions and mechanisms had also been put in place to manage the sharp increase in income. Norway's sovereign wealth fund, the Government Pension Fund Global, and the fiscal guidelines were established with the express purpose of making the mainland economy less susceptible to fluctuations in the oil price. Improved terms of trade, higher revenues and increased government spending contributed to a stronger krone and a shift in real resources towards sheltered sectors. At the same time, the fiscal rule provided a basis for growth in business sectors other than the oil industry and the public sector through the decade. Norway had a plentiful supply of labour from new EU member countries and experienced several years of high output growth. At the same time, the inflation target for monetary policy adopted in 2001 provided a sound anchor for inflation expectations.



Autumn 2008

In 2008, the expansionary period was drawing to a close. Costs had risen sharply, credit growth had been strong, the key policy rate had been raised and house prices had started to fall. Petroleum revenue spending over the central government budget had increased, but employment in traditional industries was still high. Despite Norway's high cost level, merchandise exports and supplies of goods and services to the oil industry held up well due to strong demand.

Instead of a gradual slowdown, economic growth came to an abrupt halt in autumn 2008 when the global financial crisis peaked. Demand for Norway's exports fell markedly. Norwegian banks proved to be sensitive to the credit freeze in global money markets and stopped providing new loans.[1]

However, Norwegian banks were not as exposed to loan losses – at home and abroad – as banks in other countries. The economic downturn proved to be milder in Norway than elsewhere, but the banking sector seems also to have performed its craft fairly well. Moreover, government and central bank liquidity provision measures were effective. The liquidity crisis passed quickly and a solvency crisis did not occur in Norway's banking system.

The rapid rebound in oil prices and a weaker krone provided a boost to the economy. The interest rate was lowered sharply to a historically low level and public spending increased markedly. The downturn was milder than we had expected when the interest rate was reduced – partly because oil prices proved to be higher than expected and partly because the policy measures were more effective than we had dared to assume. Therefore, we now expect to raise the policy rate at a gradual pace back to more normal levels.

The emerging economies were hardest hit by the global crisis in the late 1990s. This time OECD countries were the most severely affected. But Norway largely escaped both crises. Overall, output fell less in Norway than in other countries and is recovering more quickly. Unemployment has remained low.

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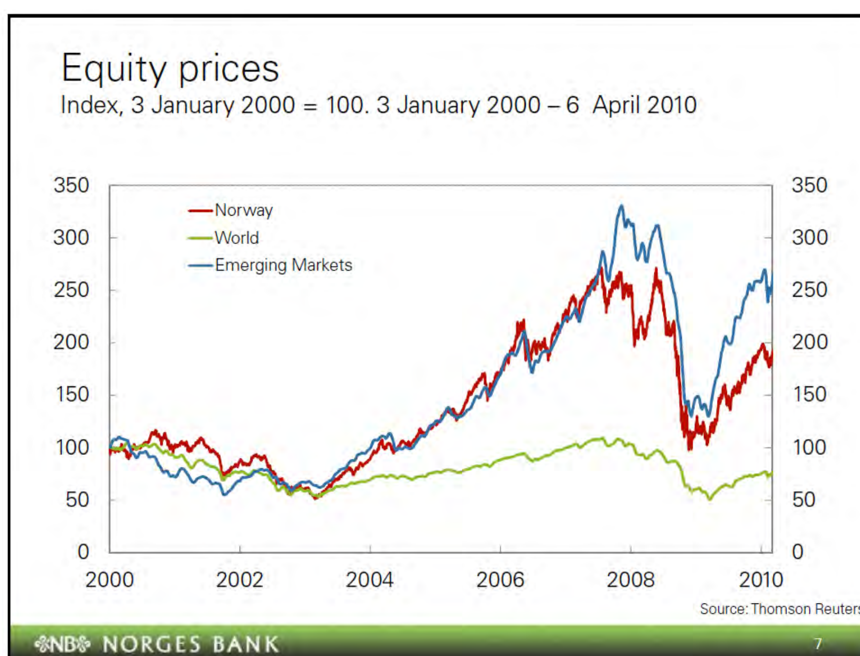
[1] IMF Country Report No. 10/24. Norway: Staff Report for the 2009 Article IV Consultation.

Norway is not unique

We cannot expect underlying forces to be as beneficial in the future. Real interest rates cannot be expected to fall. Another sharp boost to export prices is not likely. In addition, there are vulnerabilities in the Norwegian economy. Labour has never been as costly, and businesses may be at a disadvantage in tenders and competitions given the current high level of spare capacity in other countries. Moreover, it has never been more profitable to relocate activities abroad.

During the upturn, Norwegian firms fared well in spite of high costs, thanks to efficiency gains, high turnover volumes and price increases. Despite the high cost of Norwegian labour, there has been virtually full employment. Markets will be more demanding ahead. Despite the floating exchange rate, our cost level cannot be expected to fall to any great extent as economic conditions are weaker in other European countries than here.

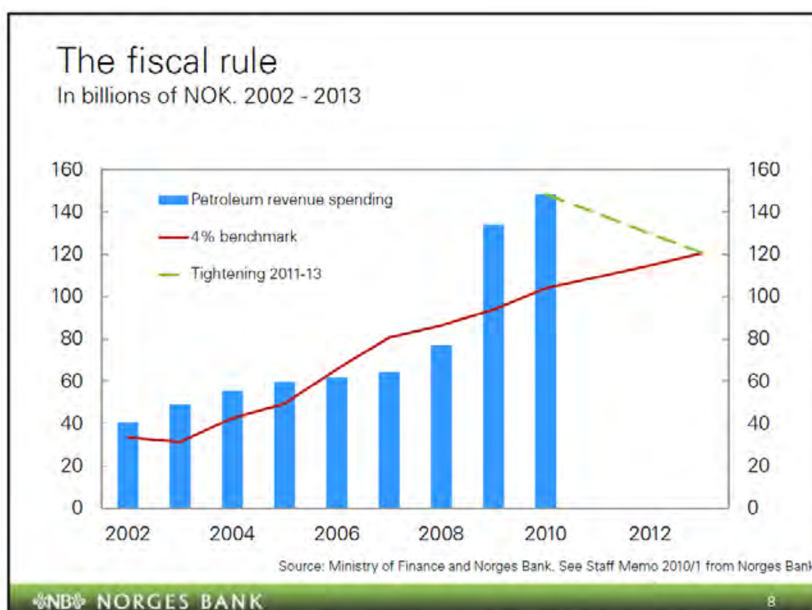
The industrial structure in Norway's relatively small economy is different from that of other advanced economies. The emergence of new Asian market economies is beneficial for Norway owing to its sizeable commodity exports and freight transport. This is also reflected in Norway's equity market.



The value of Norwegian listed companies correlates closely with the value of companies in emerging market economies. Norway is vulnerable to a slowdown in growth in Asia. In such a scenario, commodity prices might fall and the terms of trade deteriorate. Norway's high cost level could at the same time make it difficult for the business sector to shift to new markets.

Petroleum revenue spending

Government petroleum revenue spending influences Norway's cost level and trade conditions in international markets.



According to the fiscal policy guidelines, petroleum revenues should be phased gradually into the economy, approximately in pace with the expected real return on the Government Pension Fund Global, which is estimated at 4 per cent per annum. In periods of high or rapidly rising unemployment, the use of petroleum revenue can be increased, and, inversely, fiscal retrenchment is needed during periods of high economic activity and resource scarcity.[2]

It now appears that capacity utilisation in the Norwegian economy may return to a normal level in one and a half to two years – and with a somewhat lower unemployment rate than today. A different path can be met with an interest rate response. Our understanding of the fiscal rule is that the government budget for 2012 or at the latest for 2013 should aim at bringing down petroleum revenue spending to 4 per cent of the capital in the Pension Fund.

The scale of petroleum revenue spending – growth in public expenditure – is important for developments in competitiveness, also referred to as the real krone exchange rate, in the long term. But, in the short term, the krone exchange rate can vary widely, and it depreciated in autumn 2008 when capital sought safe havens. This helped Norwegian manufacturing in the first phase of the downturn. Since then, the krone has appreciated considerably.

In 2009 and 2010, government petroleum revenue spending shows a substantial increase and foreign investment via the Pension Fund a decrease. This leads to higher commercial demand for the Norwegian krone which directly contributes to its appreciation.

More fundamentally, the krone is influenced by the difference in activity at home and abroad and how fast the interest rate has to be increased in Norway to keep inflation low and stable.

The economic geography of Norway will change over the next 10 to 15 years. The domestic cost level and the real economy crisis abroad will put pressure on jobs and businesses in manufacturing communities.

And as mentioned, the most important, perhaps the only, instrument available to the authorities in addressing this challenge is to restrain petroleum revenue spending.

Petroleum revenue investment

Let me now turn to the Government Pension Fund Global.

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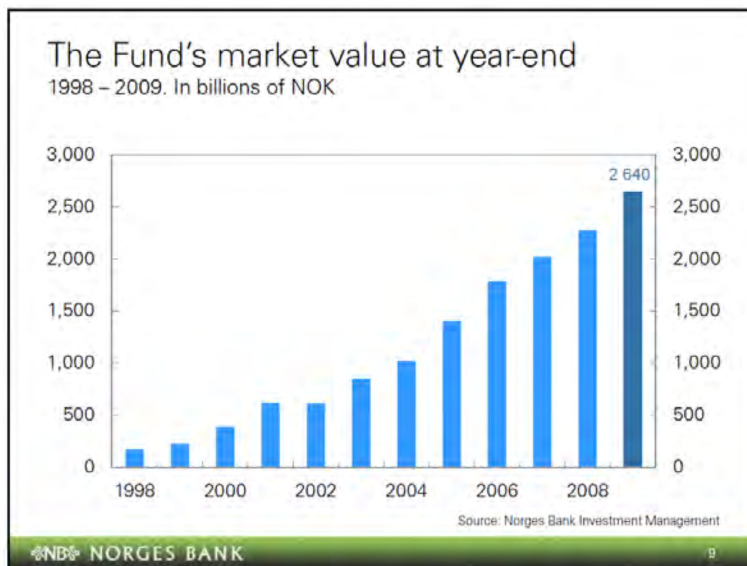
[2] See for example the National Budget for 2010, box 3.1, p. 53.

It took a generation from the time the first oil field was discovered in the North Sea until the government began to set aside economic rent. The Government Petroleum Fund was established in 1990 and the first transfer to the wealth fund was made in 1996.

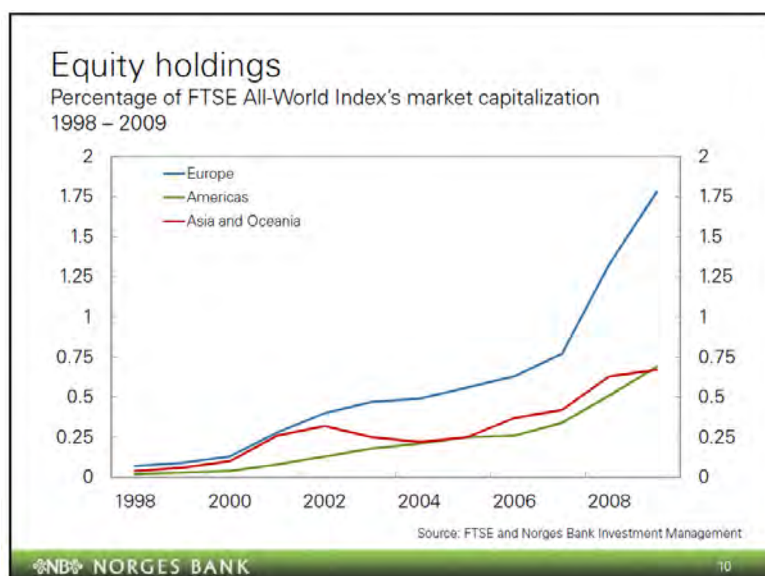


Each year since that time, as a savings plan, the government has set aside a portion of current income from petroleum activities as deposits in the Fund. Today, the value of the Fund is around NOK 2.6 trillion, or about 115 per cent of 2009 GDP in Norway.

New transfers will likely be made to the Fund for perhaps a little more than another decade. The Fund will in that case continue to grow and may reach twice its current size. The actual build-up of the Fund may span a short generation.

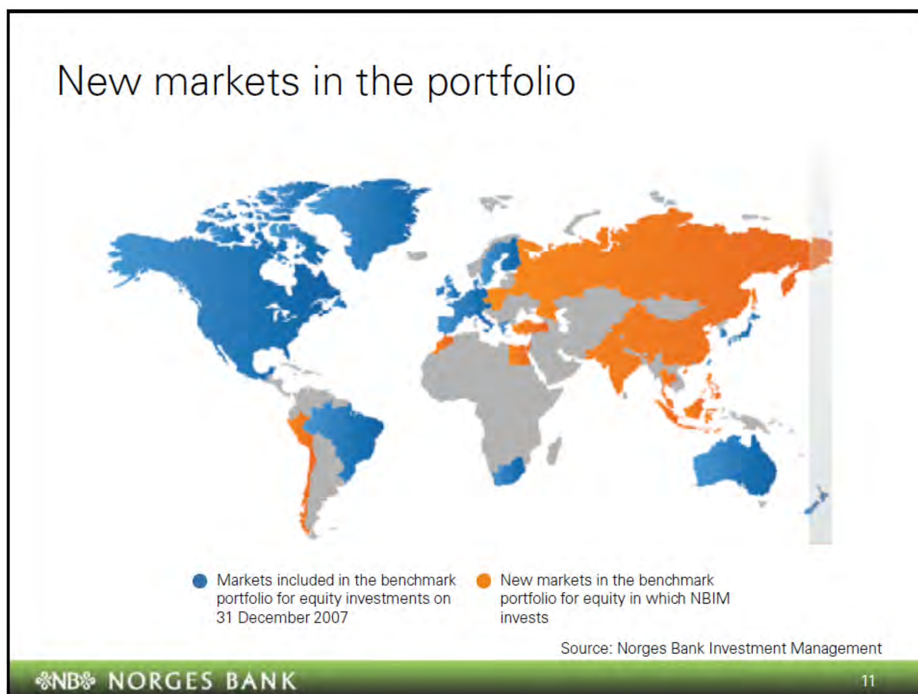
The Fund will thereafter enter a new phase. With lower revenues from oil and gas activities, it will no longer receive capital transfers from the government. When oil and gas revenues cease to provide the government with economic rent, only the annual real return on the Fund can be used on a permanent basis.

In the mid-1990s, oil prices were around USD 20 per barrel and revenues were set aside. This year the oil price must be over USD 50 per barrel to generate sufficient oil revenues to make transfers to the Fund. We must be prepared for wide variations in oil prices, and the first year without transfers of oil revenues – but rather withdrawals – may be approaching.



Increase in equity share

Under the Fund's investment strategy, more equities are purchased when equity prices fall and fewer when prices rise. Thus, the Fund purchased a large volume of equities in the period from 2001 to 2003 and during 2008 and 2009. As a result the Fund currently holds a little more than 1¾ per cent of listed European equities and roughly 1 per cent of all listed equities.



The Fund's stock holdings are spread across different countries, sectors and regions. In the early days of the Fund, the benchmark portfolio was restricted to investments in Western Europe, North America, Japan, Brazil and a limited number of countries from all over the world. Today the benchmark portfolio is more diversified and includes a large number of countries globally.

Emerging markets in the equity portfolio
December 2009

Country	Share of the portfolio	Investment (mill NOK)
Brazil	1.7 %	27 210
China	1.5 %	23 919
Russia	1.3 %	20 571
Republic of China	1.0 %	15 719
India	0.9 %	15 289
South Africa	0.6 %	9 623
Mexico	0.3 %	5 669
Turkey	0.3 %	5 299
Malaysia	0.3%	4 590
Poland	0.2 %	3 947

Source: Norges Bank Investment Management

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Emerging markets in the equity portfolio

December 2009

Country	Share of the portfolio	Investment (mill NOK)
Indonesia	0.2%	3 149
Hungary	0.1%	1 987
Thailand	0.1%	1 928
Czech Republic	0.1%	1 719
Chile	0.1%	1 688
Egypt	0.1%	927
Philippines	0.04%	628
Peru	0.02%	378
Morocco	0.02%	321

Source: Norges Bank Investment Management

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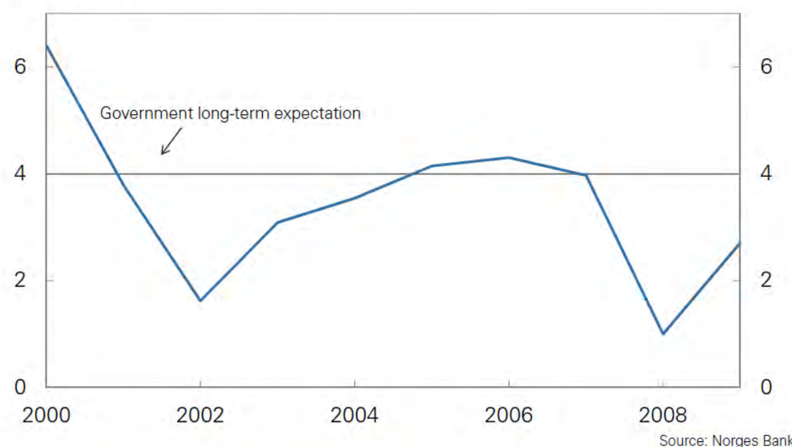
In 2008 it was decided to increase the share of emerging market assets in the Fund's benchmark portfolio. Thus, investments in these markets have grown.



The government has stated that the expected annual return on the Fund will be close to 4 per cent over time. Since its establishment, the average return has been 2.7 per cent. It was only a little more than a year ago that we witnessed the steepest fall in global capital markets in our time. By maintaining the Fund's risk profile it is fairly probable that the average return will gradually approach 4 per cent again.

Last year was the best in the Fund's history. Gains in international equity and fixed income markets led to a record annual return of 25.6 per cent in 2009.[3] However, developments in

[3] Government Pension Fund Global – Annual Report 2009.

2009 must to a large extent be viewed in light of the financial crisis and are mainly due to a reversal of the negative results in 2007 and 2008.

Multilateral approach to global challenges

Finally, let me turn to the international economic order and developments in multilateral institutions over the past few years.

The international order and Norway

In recent years, increasingly assertive non-statutory bodies have emerged in the area of international economic and financial collaboration, most notably the G20.When the global financial crisis unfolded, the G20[4] rose to the task. Nevertheless, I believe that the role of non-statutory bodies and the statutory institutions, such as the International Monetary Fund (IMF)[5], must be reconsidered to promote the necessary multilateral approach to global governance.

Norway has a long-held tradition of participating actively in multilateral cooperation and institutions has actively backed the multilateral responses to the financial crisis. As a global investor with an open market economy, Norway has a strong and vested interest in the well-being of global financial markets. This interest is shared with most market participants, large and small. We have a common interest in a market-based international order, supporting a level playing field and sound economic governance.

Lessons from the crisis

A key lesson from the global crisis is the need for multilateral cooperation and collective action. It relates to the framework for polices on prevention, resolution, reform and implementation. It also relates to the institutional set-up. The IMF has played a pivotal role in presenting the initial lessons from the crisis, in providing finance to countries with temporary balance of payments needs, and in preparing the overall framework for the international policy response. When the good times return, we must avoid memory failure and remind ourselves of these facts of life.

Shaping the global governance structure

At their summit in Pittsburgh last September, the G20 leaders "…designate[d] the G20 to be the premier forum for our international economic cooperation".

As an effective and powerful group, the G20 featured prominently in the broad international efforts to stabilise the global economy in late 2008 and early 2009. Without its prompt and comprehensive action, the consequences of the crisis would have been much worse. Among the G20 measures of 2009 were the efforts to strengthen confidence in international financial institutions, the IMF in particular, to permit it to play an effective role in tackling the crisis. Indeed, the G20 increasingly uses the IMF as an instrument of its policy implementation.

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[4] The membership of the G20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Korea, Japan, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union. The G20 was formed as a new forum for cooperation and consultation on matters pertaining to the international financial system. It studies, reviews, and promotes discussion among key industrial and emerging market countries of policy issues pertaining to the promotion of international financial stability, and seeks to address issues that go beyond the responsibilities of any one organization.

[5] The International Monetary Fund (IMF) is an organisation of 186 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Nevertheless international policy cooperation has moved out of statutory bodies and into groups of a select few, bypassing established channels and fora. Other countries are called upon to contribute to efforts agreed by the G20.

Policy action and global imbalances

The large global imbalances that contributed to the current crisis are likely to widen anew, if they are not addressed effectively. This would again put at risk the stability of the global economy. Global and prompt policy action is therefore warranted yet again. To this end, the G20 has embarked upon an unprecedented exercise in policy collaboration with the IMF. Still, the G20 lacks the legitimacy that historically has been associated with a truly multilateral framework. Its ambitious economic cooperation should be anchored in a multilateral institution. The IMF is the logical choice. With G20 merging its activities with those of the IMF, both will attain wider acceptance and legitimacy.

Success in the ambitious tasks of the G20 can only be welcomed by the rest of us. However, it is a weakness that the members of the G20 represent only themselves. Virtually entire groups of countries and regions are left out. They have no voice and no representation in the work of the G20 or in the institutions which it chooses to set up to further its agenda. This is at variance with the principles of multilateralism and international cooperation that have prevailed since the end of the Second World War. Over time, this could easily weaken not only the G20 process, but also the IMF as it will be perceived as increasingly guided and controlled by the G20.

A strong institution like the IMF must be at the centre of multilateral economic and financial cooperation. Virtually all the countries of the world participate and are represented in the IMF. To be able to continue to play an effective role, the IMF needs to enjoy confidence and trust, and to be seen as having a legitimate structure of governance. Last but not least, the IMF needs to be financially strong, to have at its disposal financial resources commensurate with its tasks, including the ability to provide prompt and significant financial support when needed.

In closing, I would emphasise certain key principles:

- ***First, systemically important countries need to collaborate effectively on consistent economic policies.*** Their success is vital not only for their own good, but also for that of others, including small open economies.
- ***Second, this collaboration should be anchored in a multilateral and statutory-based system of representation***, for example through constituencies, where smaller countries would participate, even if indirectly.
- ***Third, the constituencies should have rotating representation***, where small countries, at least periodically, could participate directly.

Thank you for your attention.