Øystein Olsen: Economic perspectives

Speech by Mr Øystein Olsen, Governor of the Norges Bank (Central Bank of Norway), to invited foreign embassy representatives, Norges Bank, Oslo, 3 April 2014.

* * *

The speech is based on the annual address 2014, Monetary Policy Report 1/14 and previous speeches. Please note that the text below may differ slightly from the actual presentation.

Accompanying charts can be found at the end of the speech and on the Norges Bank website.

Excellencies, Ladies and Gentlemen,

First of all, I would like to welcome you once again to Norges Bank.

This year is the bicentenary of the signing of the Constitution of Norway. Two hundred years ago, Norway was a poor country on the periphery of a Europe that was then the world's economic centre of gravity.

For the 112 sworn representatives, popularly known as the men of Eidsvoll, who took their places as the Constituent Assembly in spring 1814, the atmosphere was full of hope for freedom and a better future. Several of them had spent time abroad and had been influenced by philosophers and by the American and French revolutions. The Norwegian Constitution was inspired by the ideas they brought home. Absolute monarchy under the Danish king was to be replaced by the sovereignty of the people and the separation of powers. Institutions with clearly distinguished roles would prevent the arbitrary use of power and foster confidence.

In the discussion at Eidsvoll, Christian Magnus Falsen, a key member of the Constituent Assembly, said that no state can exist without a well-functioning monetary system. Another prominent member of the Assembly, Count Wedel Jarlsberg, insisted that the nation must have its own bank.

The people's elected representatives took responsibility for the monetary system, as stated in Article 75 of the Constitution: *«It devolves upon the Storting to supervise the monetary affairs of the Realm».*

The Storting delegated the task of supervising the monetary system to Norges Bank, which was established in 1816. The king would no longer have the authority to print money at his own will.

At its inception, Norges Bank's head office was located in Trondheim, a twelve-day journey from the government in Christiania, and even farther from Stockholm, giving the central bank a geographical – and not just formal – distance from the government authorities.

Much has happened since 1814. Norway no longer lags behind other western economies. Inflation is low and stable. We have established a clear division of responsibility for economic policy and well developed institutions founded on the Constitution written at Eidsvoll 200 years ago.

Chart: Shift in the world's economic centre of gravity

In 1814, the great powers of Europe dominated world trade. The world's economic centre of gravity has since then shifted westward. Today, in the 21st century, the centre of gravity is moving across the Pacific to Asia.

When China became a member of the World Trade Organization in 2001, its foreign trade was 30 percent of that of the US. The Chinese economy has since grown at an unprecedented pace. In 2013, China overtook the US as the world's largest trading nation. Ample labour supply and low cost levels have given China and the other emerging economies of Asia strong competitive advantages in international markets.

The global flow of credit over the past 15 years has taken an untraditional direction – from relatively poor countries with strong economic growth to more prosperous, mature economies experiencing lower growth. For a long period, this shift contributed to substantial imbalances in the global economy. Ample supply of credit in western economies pushed down borrowing rates.

Facing competition from Asia, it became relatively less profitable for firms in the west to invest in new productive capacity in their home countries. Instead, cheap credit was widely used to finance consumption and housing, particularly in the US and Europe. Banks and financial institutions were, in practice, free to fuel credit growth.

In retrospect, it is clear that a vast amount of capital was squandered. Many businesses and a number of countries are struggling with high debt levels. Governments that ran economies on cheap credit are now paying a high price in the form of austerity measures and unemployment. In parts of Europe, unfinished infrastructure and empty buildings are not uncommon sights.

Chart: Productivity growth in advanced economies

Productivity growth has been declining in advanced economies since the beginning of the 2000s. The willingness to invest has been low since the financial crisis. To what extent this is related to the economic downturn remains to be seen. Better times may eventually entice investors, but it is also possible that the substantial changes in the global economy have had a more lasting effect on the willingness to invest and the growth capacity of western economies.

Chart: Real wages in mainland Norway, the US and Germany

A demanding restructuring process is underway in the traditional industrialised countries. In the US and Germany, real wages have barely risen since the turn of the millennium. Income inequality has deepened. This may in part be related to the global change in the price of labour. In other countries, particularly in Europe, economic restructuring is throwing a large number of people into unemployment. Over 26 million people are now unemployed in the EU today, almost 10 million more than in 2007.

Low growth, high unemployment and high debt levels are not a good combination. Even though there are signs of a moderate revival of activity abroad, growth may remain low for a protracted period.

Chart: Real wages and productivity for mainland Norway

Real wage growth in Norway has diverged substantially from that observed in Germany and the US. This is attributable to the sharp price rise for Norwegian goods in recent years. Norway's terms of trade have improved. The gains are shared between owners and workers.

Real wage growth in Norway has been considerably higher than productivity growth.

But the economic picture for Norway may be changing. We cannot assume that Norway's terms of trade will continue to improve. Investment in the petroleum sector is levelling off. Output growth in the mainland economy has slackened.

When activity in the petroleum sector eventually declines, there will also be a need for economic restructuring in Norway. The business sector will have to seek new markets, where competition may be intense. Restructuring may prove particularly demanding given Norway's high cost level.

Although restructuring will be a gradual process and may lie some years ahead, Norway may find that sustaining growth and keeping unemployment low in the coming years may become a challenge more on a par with that facing other economies today.

The economic policy framework matters. Fiscal policy follows the fiscal rule, which aims to ensure a sustainable level of petroleum revenue spending over the long term. In the event of major aggregate demand shocks, fiscal policy, in line with the fiscal rule, can be used to alleviate the situation in the short term, as evidenced during the recent financial crisis. But an imbalance arising from a cost level that is too high and weak competitiveness cannot in the long term be addressed by means of an expansionary fiscal policy. This approach could, on the contrary, amplify the problem by crowding out businesses.

The fiscal policy stance can affect the growth capacity of the economy. Government regulation and various features of the tax system can influence corporate decisions with regard to localisation, investment and technology. Other measures can affect the labour force and the functioning of the labour market.

Over time, real wages must move in line with productivity and real wages. The social partners determine wage growth. We have seen in previous periods that they pull in the right direction when that is needed. The alternative could be a more painful adjustment with higher unemployment.

The objective of monetary policy is low and stable inflation over time, while at the same time smoothing fluctuations in output and employment.

As long as inflation is low and stable, the krone can act as a buffer during periods of adjustment. We cannot, however, rely on a depreciation of the krone to ensure Norway's competitiveness in the longer run.

Monetary policy cannot influence the long-term growth capacity of the economy. The challenges associated with low growth and changes in business structure must be addressed using other policy measures.

Chart: Low growth results in low interest rates

Monetary policy easing and low interest rates do not lead to longer term higher growth. The inverse is true: prospects for persistently weak growth result in low interest rates for a sustained period.

In order to prevent deflation and recession, the central banks of major advanced countries have implemented extraordinary measures to keep both short- and long-term interest rates low. The medicine has worked. The US economy in particular is on the road to recovery. Financial market participants see opportunities, not just problems. However, in a number of emerging economies volatile capital flows are creating problems. High debt growth and rising house prices may constitute a risk. The recovery abroad is fragile.

The key policy rate is also low in Norway. Our inflation target is slightly higher than that of other European countries. As a result, inflation and nominal interest rates in Norway are also slightly higher. But prospects for a persistently low interest rate level internationally will inevitably also have consequences for Norway. The real interest rate in a small open economy cannot in the long run differ substantially from that of our closest trading partners. Given the prevailing long-term interest rates abroad, it will likely take a number of years for interest rates in Norway to move up towards a level that was previously considered to be normal.

When the drafters of the Constitution gathered at Eidsvoll 200 years ago, there were no private banks in Norway. It was not until the latter half of the 1800s that a private banking system truly came into being. Norges Bank acquired its present-day role as lender of last resort.

With private banking came banking crises. The 1899 crash in Christiania triggered the first serious banking crisis in Norway. A real estate bubble in the capital burst and house prices plummeted. It took more than 100 years for real house prices in Oslo to return to their pre-crisis level.

Banks play a key role in the payments system and channel credit from savers to investors. If the flow of credit dries up, problems will rapidly spread through the entire economy, as witnessed during the latest financial crisis.

This is why the authorities ultimately intervene in support of failing banks. This happened during the Christiania crash – and it has occurred many times since then, both in Norway and other countries.

It may be necessary to provide support to banks in distress, but it comes with a major drawback: Banks will expect support also in the future. The phenomenon is called moral hazard. Although this is not about morals, but about incentives. The banks' creditors are induced to charge low interest rates on loans to banks. This leads to underpricing of risk, which may in turn lead to excessive risk-taking in the banking sector.

The problem must be solved down to its roots. No bank should be promised life eternal.

A new regulatory framework for the recovery and resolution of banks is underway. All banks must have a plan for orderly resolution. It must be possible to allocate banks' losses to both owners and creditors, while core banking services continue.

For a market to function properly, there must be scope for new entrants and for the closure of loss-making companies. This also applies to financial markets. The banking sector is characterised by large entities and complex products. Banking regulation is also complex and rich in detail. If the authorities succeed in developing a system for resolving failing banks, perhaps we can take one step back with regard to other detailed regulations.

The work on reforms that has been engaged abroad must be followed up in Norway. A national bank resolution authority must be designated. It should be placed in a unit under the Ministry of Finance. This is not a natural role for a central bank.

Among Norges Bank's key tasks is the management of Norway's foreign exchange reserves. This responsibility has followed the Bank since its establishment in 1816, first in the form of silver and gold reserves. Later, reserves were expanded to include bank deposits and securities in various currencies.

Norges Bank was charged with managing the Government Petroleum Fund when the first capital transfers were made to the Fund in 1996. This was a natural extension of our responsibility for managing foreign exchange reserves.

The aim of the Government Pension Fund Global, as it is now called, is to ensure that the income from our oil and gas resources will also accrue to future generations.

The Fund is the nation's family silver. It is no longer held in Norges Bank's vault, as it was during the periods of the silver and gold standards. The Fund is invested in fixed-income securities, equities and real estate across the world. When Norges Bank had finished collecting the silver tax around 1820, the Bank's silver holdings came to somewhat more than 50 grams per inhabitant, which is the equivalent of about one silver spoon. The value of the Fund has just recently exceeded NOK 5 trillion, or about NOK 1 million per inhabitant.

Chart: Return on Fund accounts for one third of its total value

The Fund's results have been favourable. Since 1998, the cumulative return on the Fund has been close to NOK 1 800 billion, which is more than a third of the Fund's total value. So far, our nation has earned a solid return on its investments.

Quite paradoxically, low growth and low interest rates abroad are probably the main factors behind the solid performance of the Fund over the past two to three years.

Chart: Annual return on the GPFG

Since the end of the 1990s, a persistent fall in yields has driven up government bond prices. In recent years, the unconventional monetary policy measures of the world's major central banks have contributed to even lower interest rates and higher prices for equities and other securities. This has resulted in above-normal returns on the Fund's investments. But today there is no longer room for a considerable fall in interest rates and equity prices have risen to fairly high levels.

Chart: Return consists of two elements

Our measure of final return includes both capital gains and direct cash flows, which comprise dividend and interest income. The market value of the Fund and its investment returns will therefore swing in tandem with equity and bond prices. This may draw a veil over the progression of the Fund's underlying earnings.

In the long run, it is the Fund's cash flow that makes a permanent contribution to our national income. The Fund's cash flow is therefore a good cross-check for measured capital returns.

Chart: Cash flow from the GPFG and petroleum revenue spending over the fiscal budget

The cash flow presently matches the actual level of petroleum revenue spending over the fiscal budget – of about 3 percent of the Fund's value. This is reassuring since it implies that the Fund's capital is not being depleted.

Above all we should recognise that future returns on the Fund are uncertain. Ultimately, returns depend on the pace of growth in the world economy and the share of that growth that accrues as value in the companies and bonds in the Fund's investment portfolio. These variables are uncertain. Growth in the world economy may come to a halt. Governments may default on interest payments. Real properties may fall in value when bubbles burst.

To achieve returns, we must take on risk. The Fund features a very long investment horizon and a sizeable capacity to bear short-term risk. If we can exploit these distinctive features when making investment choices, it should be possible to obtain a return in excess of average market return.

Shareholders are last in line when company profits are to be distributed. They bear a considerable risk. As compensation, shareholders have received a higher return over time – a risk premium. It is a good strategy for a fund such as ours to exploit this risk premium to seek excess returns. This is why the chosen allocation to equities is relatively high.

In addition, a reasonable distribution between bonds and equities can contribute to reducing the Fund's overall risk, as bond and equity prices tend to move inversely. The bond portfolio may thus be seen as a kind of hedge against a drop in equity prices.

In recent years, the Fund has also invested directly in real estate. In the light of its size and long horizon, the Fund is well positioned to make gains in low liquidity markets.

Real estate investment is an example. The mandate provides for an increase in the real estate allocation up to 5 percent, while the allocation to fixed-income instruments is to be reduced from 40 percent to 35 percent.

A few years from now, almost two-thirds of the Fund will thus be invested in real assets. This is a fairly high share. A pertinent question may still be whether as much as a third of the Fund should be invested in low-yielding instruments. In the long run, a bond allocation of 20–25 percent should suffice to maintain the Fund's needed hedge against a fall in equity prices.

Risk management must encompass the Fund's overall risk. This can only be achieved if total risk is managed and controlled. This is why the Fund is an integrated entity located in Norges Bank.

Norges Bank works to preserve the Fund's long-term financial value. Responsible investment is part of that task. As a long-term financial investor, the Fund stands to benefit from sound and sustainable growth in the companies and markets included in its investment universe.

We use a variety of instruments to exercise our ownership rights. We engage in close dialogue with companies, investors and regulatory authorities. We vote at shareholder meetings in line with pre-defined principles and publish our voting results on a regular basis. We also submit shareholder proposals and participate in consultations based on the fundamental principles that we apply in the exercise of ownership rights.

Norges Bank integrates the considerations relating to corporate governance, the environment and social conditions into the investment process. Because the Fund is a long-term financial investor, we place considerable emphasis on our role as responsible investor. The overriding goal, which is the highest possible return at an acceptable level of risk, remains firmly established.

If Norges Bank is assessed using criteria other than return and risk, its mission will become unclear. This might also impact return performance. There must be no doubt as to the objective of investment management.

Norway's enormous economic progress since 1814 has not been linear. Rapid population growth and food crises in the latter half of the 1800s led to the massive emigration of close to 1 million Norwegians to America. Norway gradually became an industrialised country, and trade and shipping provided our new nation with much needed income. Moreover, an abundance of natural resources has been essential for our country's prosperity. Norway never did become a true manufacturing nation.

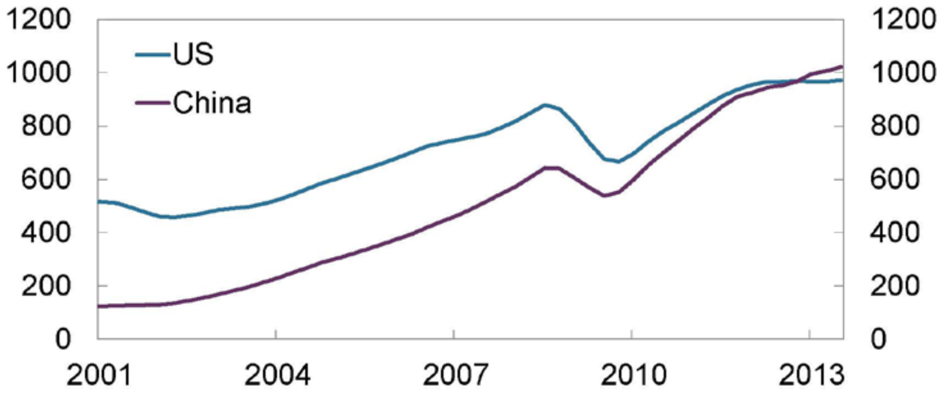
We cannot expect the strong growth in national income we have seen in recent years to continue. Norway is not immune to shifting circumstances and external shocks. But we have a good starting point. The beneficial tailwinds have been put to good use and Norway is in a solid position to tackle challenges when the winds shift.

The Constitution is the foundation of modern Norway. This year's bicentenary of the Norwegian Constitution is an occasion to remember the importance of good institutions that have clearly defined roles. This is essential for stability and progress.

Thank you for your attention.

International trade[1] for the US and China

Current prices. Four-quarter moving average. In billions of USD. Quarterly figures. 2001 Q1 – 2013 Q2

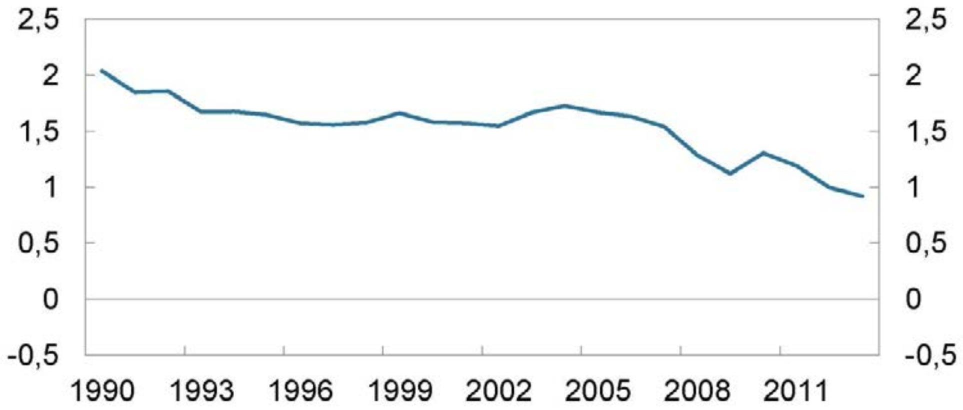


1) Exports and imports of goods

Source: Thomson Reuters

Productivity growth in advanced economies[1]

Percent. Eight-year moving average. Annual figures. 1990 – 2013[2]

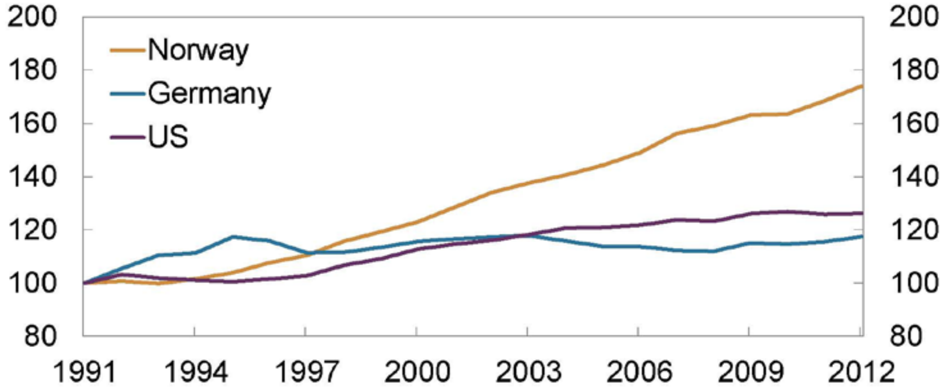


1) Annual growth in GDP per employee for the euro area, US, UK and Japan (GDP weights)
2) Figures for 2013 are projections

Sources: IMF and European Commission (AMECO)

Real wages[1] in mainland Norway, US and Germany

Index. 1991=100. Annual figures. 1991 - 2012

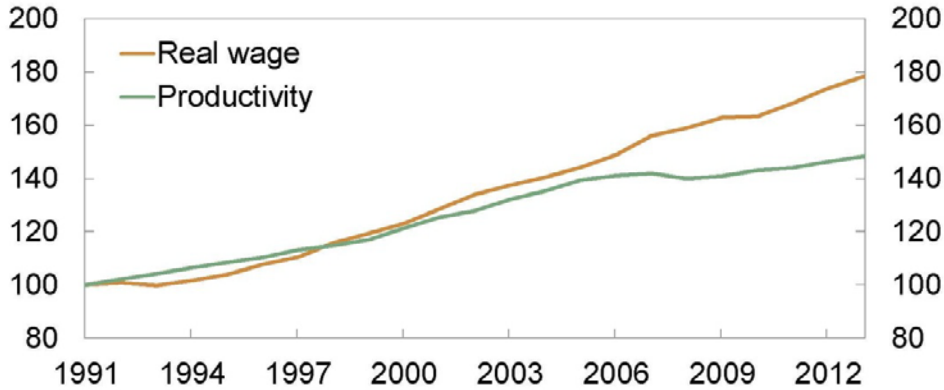


1) Real wages defined as hourly labour costs deflated by consumer prices

Sources: OECD and Statistics Norway

Real wages[1] and productivity[2] for Norway

Index. 1991=100. Annual figures. 1991 - 2013

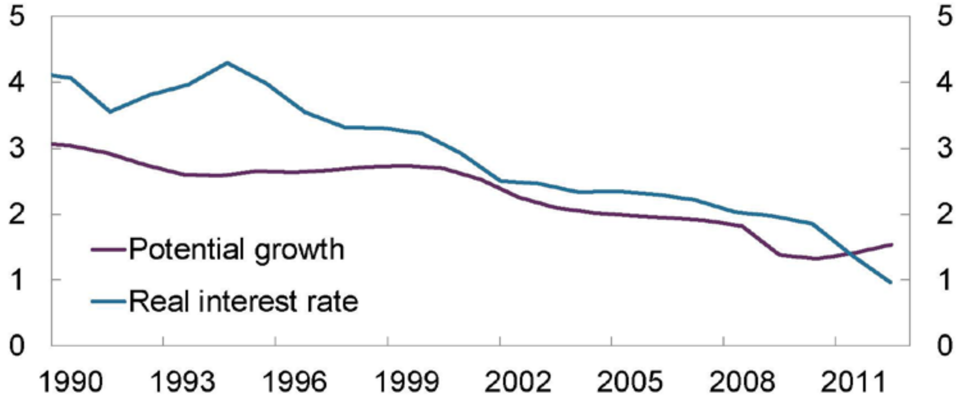


1) Real wages defined as hourly labour costs deflated by consumer prices
2) Gross product per hour worked at constant prices

Sources: OECD and Statistics Norway

Long-term real interest rates[1] and potential growth in advanced economies[2]

Percent. Annual figures. 1990 - 2012

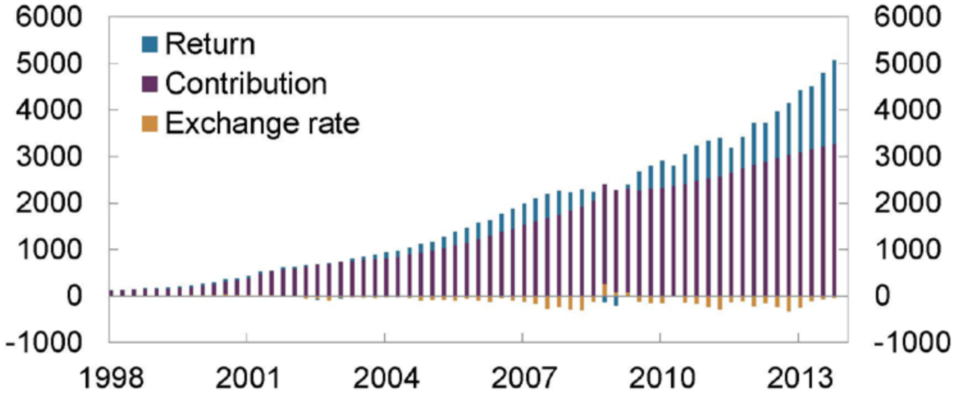


1) Ten-year government bond deflated by consumer price inflation. Three-year average
2) Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, UK and US

Source: OECD

Cumulative value of the Government Pension Fund Global (GPFG)

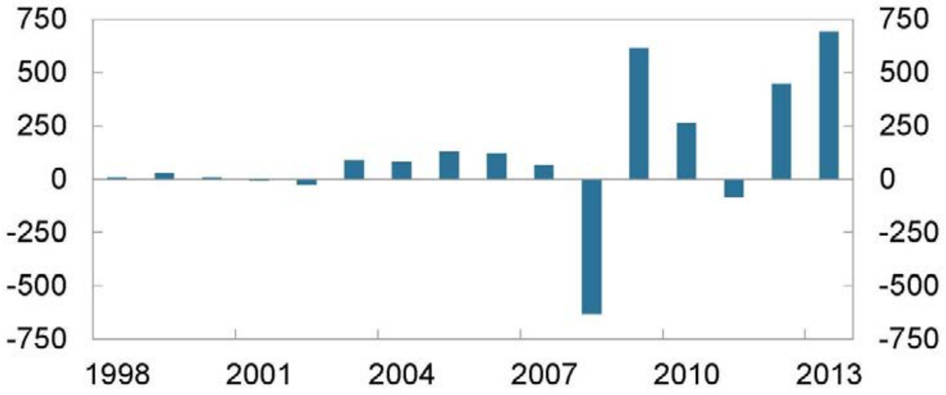
In billions of NOK. Quarterly figures. 1998 Q1 – 2013 Q4



Source: Norges Bank

Annual return on the GPFG

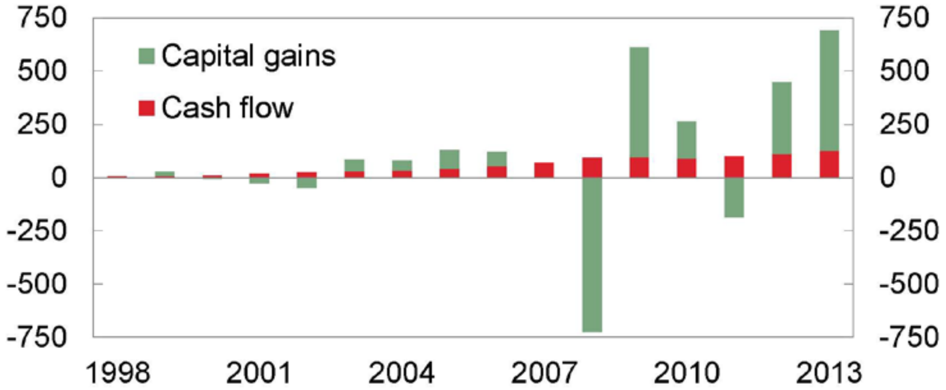
In billions of NOK. Annual figures. 1998 - 2013



Source: Norges Bank

Annual return on the GPFG divided into capital gains[1)] and cash flow[2)]

In billions of NOK. Annual figures. 1998 - 2013

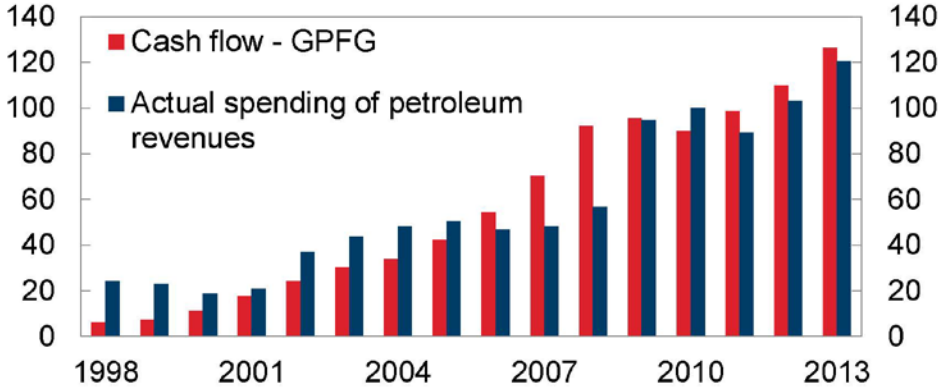


1) Effect on the GPFG of change in valuation of GPFG assets
2) Sum of dividend and interest income from fixed-income securities and rental income from real estate

Source: Norges Bank

Cash flow from the GPFG and petroleum spending[1] over the fiscal budget

In billions of NOK. Annual figures. 1998 - 2013



1) Structural, non-oil deficit

Sources: Ministry of Finance and Norges Bank