How to rebuild confidence in markets? The Norwegian experience
EFTA conference on small European economies: weathering the storm of the financial and economic crisis
Brussels, 16 November 2011
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The financial crisis that set in in 2008 had limited effects on the Norwegian economy. GDP excluding the petroleum sector (mainland GDP) contracted in 2009, with 1.8 pct less than many other countries. Growth had been very strong in the years before, between 4 and 5 pct per annum in 2004-2007, and it picked up again quickly. The unemployment rate was very low when the crisis emerged. The unemployment rate rose from the abnormally low level of 2½ pct in 2007/2008 to around 3½ pct in 2009/2010, which historically has been a normal level. After that it has declined again to around 3¼ pct.

There are four main reasons why the Norwegian economy has been more mildly affected than most other OECD countries:

1. The Norwegian financial system avoided a crisis.
2. House prices were elevated, but it has not been a housing bubble that burst.
3. The effects of the strong recession in other European countries had limited effects on the Norwegian economy because of the different industry structure.
4. The Norwegian authorities’ financial room for manoeuvre is large and the policy reactions have been strong.

Let me go more into the four above-mentioned points.

Why no domestic financial crisis
Norwegian financial institutions hardly had any direct exposure to the US subprime instruments or to other toxic assets. And their exposure to PIIGS countries now is very limited. Norwegian banks were, and are of course, strongly integrated into the international financial markets. They had exposure to foreign financial institutions that came into trouble, but were able to limit loss to negligible levels. More serious was the near closedown of the interbank market internationally, and especially reduced availability of US dollar funding. It was special dollar funding out of London that became scarce, but the larger Norwegian banks with representation in New York were able to tap that market. In October 2008, an acute situation with lack of bank liquidity occurred, but it was quickly resolved by measures implemented by Norges Bank, the central bank, and the Government. Banks’ loan losses increased somewhat during 2009, but were much more contained than feared in
late 2008. So far during the present turmoil, the funding situation for Norwegian banks has been better, and much better than experienced by many euro based banks. However, Norwegian banks’ funding costs have increased somewhat.

The resilience of the Norwegian banking system was a result of lessons learned after the Norwegian banking crisis in 1987-1993 and the fact that the Norwegian economy was relatively mildly affected by the international recession. After the banking crisis in the early 1990s, the Financial Surveillance Authorities have followed the Norwegian banks very closely. Financial institutions were, and are, surveyed and regulated on a consolidated level making it impossible for them to set up shadow banking operations as was done in the US. The regulatory requirements as to the quality of core capital of banks were not diluted as was the case in many other countries, also in other European countries. The risk management systems in banks were strongly improved after the banking crisis twenty years ago, and remained well in place also in the good years prior to the financial crisis. That is an important reason why banks’ exposure to toxic assets has been very limited. Banks have been offered such assets, but declined to invest in them. And the quality of the banks’ credit assessment was retained. In one area did banks, Norwegian and Swedish, misjudge risk. That was when expanding in the booming Baltic countries. Here losses became large, but the total exposure in these countries was limited compared to the banks’ total assets and capital.

The housing market
House prices in Norway increased strongly in the years up to mid 2007. The interest rate was long kept low, the limited taxation we had on houses was removed, households’ income growth was strong and a new mortgage product with no mandatory amortisation was introduced. As Norges Bank gradually increased the interest rate, house prices started to decline in the second part of 2007. Norges Bank was happy with the cooling down of the housing market and construction activity. When the financial crisis exploded in autumn 2008, the house prices had already corrected down somewhat. However, the price decline steepened after the fall of Lehman Brothers as banks increased mortgage rates and tightened their credit standard as a result of the malfunctioning of the interbank market. The combination of the liquidity measures taken by Norges Bank/the Government and Norges Bank’s large rate cuts in December 2008 and during the spring of 2009 resulted in a turnaround in the housing market. House prices started to rise again already in early 2009, and have continued up after that.
Instead of triggering a steep decline in house prices, the policy reactions to the financial crisis saved the housing market from a downward trend that the tightened monetary policy had started in 2007. House prices are now well above the peak level seen in 2007, and there is a risk that continued low interest rates will create a housing bubble going forward.

The international recession had limited effect on the Norwegian economy
The effect on the Norwegian export and manufacturing sector of the recession in other countries was limited. Norway is a small and open economy, but its exports mainly consist of commodities, semi-finished goods and equipment for offshore oil and gas exploration. In addition, investment goods for oil and gas search and exploration at the Norwegian continental shelf represent a major part of the manufacturing sector’s production. Demand for commodities, oil and gas did not collapse as did demand for machinery for manufacturing, trucks and other vehicles. A price collapse in the commodities markets was avoided because continued strong economic growth was ensured in China because of strong stimuli measures. China uses about 50 pct of the world’s metal production and about 10 pct of world consumption of oil. For a short period, the oil price fell to around USD 40 per barrel, low compared to the peak of about USD 140 in early 2008, but high compared to historical levels. The oil companies’ investment plans were lowered somewhat after the oil price decline, but did not affect actual investments in the petroleum sector until a year later. The planning horizon for offshore petroleum investments is longer than for many other types of investments. An oil price above USD 100 a barrel during the 2011 turbulence is an important reason for the Norwegian economy’s resilience also this time. The optimism in the petroleum sector now is sky high, and oil companies are planning for strong investment growth going forward.

The Norwegian economy has been more resilient than most other European economies because of its dependence on oil, gas and other commodities and because of the continued strong growth in emerging economies. A collapse in the oil and gas market would have had strong negative effects on the Norwegian economy. We would probably have seen that if growth in the emerging economies had collapsed, or if the recession had happened some 20 years ago when emerging economies only played a minor role in the world economy.

Strong policy reaction – large room for manoeuvre
The measures taken by the Norwegian authorities to stimulate the economy and to defend the domestic financial system in 2008-2009 were strong. Norges Bank’s policy rate was cut from 5¾ pct to 1¼ pct. The economy was at boiling point and the monetary policy had been tightened, and
was planned to be tightened further when the international financial crisis worsened in autumn 2008. Norges Bank therefore could slash its policy rate more than most other central banks.

The fiscal policy of early 2009 turned very expansionary. The OECD’s estimates of general governments’ underlying budget balance indicated stronger fiscal stimuli in Norway in 2009 than in OECD countries on average, than in the euro area on average, and about in line with the fiscal stimuli enacted in the US and UK. Most of the fiscal stimuli in Norway were on the expenditure side of the budget.

The Government established two funds to secure the functioning of the Norwegian capital and credit market; one fund with the purpose of purchasing bonds issued by companies and one fund where banks could obtain core capital if they were locked out from normal channels because of a malfunctioning equity market. Only small fractions of the capital allocated to the two funds were used as the capital market quickly recovered and functioned better during the spring of 2009 than feared at the beginning of the year. In the early phase of the crisis, just after the collapse of Lehman Brothers, Norges Bank provided banks with dollar funding and established a scheme where banks could exchange covered bonds with Norwegian Government bonds that banks could use to obtain liquidity in the market.

The Norwegian economy was one of the European economies that initially was most mildly hit by the international crisis, but also one where the policy reactions were among the strongest. That certainly contained the total effect on the Norwegian economy and resulted in a quick turnaround.

It could be considered unfair to compare the Norwegian economy with that of other European countries, because of the sovereign wealth fund the oil revenue has made it possible to accumulate. To some extent it is true that Norway is in a special situation, and the policy reactions reflected the authorities’ large financial room for manoeuvre. But it is important to remember that the financial solidity of the Government is the result of fiscal discipline during years when fiscal discipline was not a necessity, i.e when the Government’s income growth was high. It has been a broad political agreement in the Parliament that the Government’s revenue from the petroleum sector should be accumulated in a sovereign wealth fund, and that only the fund’s estimated real return should be used in the annual budgets. This fiscal policy rule is constantly under attack from interest groups, from some political parties, and from ad hoc groups of the electorate. During the last 10-15 years, the parties forming the consensus behind the policy rule have constantly had to explain why a
certain road cannot be built, why there is waiting time for certain treatments at hospitals and why
the capacity in nursing homes is not sufficient, despite the fact that the Government runs large
surpluses. It is demanding not to spend money when the Government’s purse is full.

Sweden and Finland, two EU countries, one also an EMU country, are examples of countries that
have come through the crisis financial unscathed without the help of oil revenue. Both countries
were hit hard by the international recession. Finland’s GDP declined by 8 pct in 2009, more than
Ireland’s, and Sweden’s GDP declined by 5 pct, about as much as Italy’s. Among all western
European countries, Finland and Sweden were among the hardest hit by the recession. But their
recession did not trigger a domestic financial crisis. After their crisis in the early 1990’s Finland and
Sweden enacted many reforms, including fiscal rules saying the budget on average should be in
surplus during an economic cycle. The regulation of banks and surveillance of them were also
improved. The same was the case with the banks’ own risk management. The result has been a
gradual reduction in government debt after mid 1990 and a resilient financial system. As in
Norway, fiscal policy rule is founded on a broad political consensus. It is worth noting that Finland,
in addition to Luxembourg, is the only EMU country that never has violated the EMU budget rule
that the budget deficit should not exceed 3 pct of GDP.

It was a mistake of the EU to only set a guideline for maximum limits on deficit and debt, 3 and 60
pct respectively. These limits were more and more considered as the norm for a sound deficit and
debt level. The norm should rather have been something similar to the Swedish and Finnish fiscal
policy rules.