Comments on "Monetary policy in Norway – experience since 1992"

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It is always risky to comment on another country and to offer policy advise, especially when the country is not that familiar to you and is performing as well as Norway has over the past few years. Unemployment in Norway during 1996 averaged just 4.5%, while real growth was 5.1% – higher than that of any G-10 country. Inflation, meanwhile, was a mere 1.3%; the surplus on the current account was 6.5% of GDP; and the government's budget surplus was 6.3% of GDP. By way of comparison, I would note that Canada's unemployment rate during the same period averaged 9.7%, more than double Norway's rate, and its real rate of growth was only 1.5%. Its current account balance and public accounts both showed a modest deficit. The only major Canadian economic variable that was similar to that of Norway was our inflation rate, which stood at 1.6%.

Nevertheless, as a Canadian policy-maker, I cannot help but feel a certain affinity for Norway. Both Canada and Norway are (relatively) small open economies, in close proximity to a much larger industrial power. Both economies have large government sectors and a tradition of generous social assistance. Both are heavily reliant on the export of natural resources and are blessed with abundant supplies of oil and natural gas. While Canada's recent economic performance has been less than one might have hoped for, some of the lessons that we have learned operating under a flexible exchange rate and somewhat different monetary policy arrangements than Norway might nevertheless be of interest to Norwegian authorities.

Short-run demand pressures

The immediate challenge facing fiscal and monetary authorities in Norway would appear to be containing the excess demand pressures that have

* The views expressed in this document are those of the author and do not necessarily reflect those of the Bank of Canada.

emerged in the last two years and that now threaten to push inflation well beyond the 1.0 to 3.0% range that it has moved within since 1991. In a country operating under a more flexible exchange rate arrangement, responsibility for countering inflationary pressures and stabilizing the real economic activity would fall on the monetary authorities, who would raise interest rates causing monetary conditions to tighten and thereby dampen excess demand. While Norway officially operates under a flexible exchange rate system, and should have the independence to respond in this manner, the primary responsibility of the monetary authorities as described in the Royal Decree of May 1994 is to "[maintain] a stable krone against European currencies, based on a range of the exchange rate maintained since the krone floated on 10th December 1992." Responsibility for short-run stabilization, therefore, rests with the fiscal authorities, which are expected to stimulate or suppress economic activity, as appropriate, through discretionary changes in spending and taxation – while simultaneously ensuring the "long-term management of public resources."

This is clearly a challenging mandate for fiscal policy. In most industrial countries, it is all but impossible for fiscal policy to respond to cyclical fluctuations in a timely and delicate manner. In Norway, however, fiscal policy has the added responsibility of overseeing the long-run management of public resources. While the two functions may be complementary, concern might be raised about the risk of overburdening a single policy instrument with two rather ambitious objectives. The situation becomes even more complex when one realizes that the budget position of the government is already in significant surplus and that further tightening would only raise it further.

Unfortunately, as Qvigstad and Nicolaisen note, this policy dilemma is not unusual for Norway. As a large energy exporter, its economy is often subject to different shocks than its major trading partners. A fixed currency arrangement with other economies which often find themselves at a different phase of the business cycle is not an obvious or comfortable solution for Norway.

"Given the movements in German interest rates over the last 10 years, it might be closer to the truth to say that changes in German monetary policy have generally aggravated the Norwegian domestic cycle." (p. 124)

"Norway may thus expect to *continue* to be out of phase with the cycles in other European countries." (p. 124)

The Solidarity Alternative, a centralized wage bargaining process and explicit social contract in Norway, might be used to dampen wage pressures and to help preserve Norway's international competitiveness, but voluntary wage restraint programs such as this are seldom successful in the presence of sustained labor shortages. As a consequence, there would not seem to be any obvious or simple solution to the policy dilemma presented in Qvigstad and Nicolaisen's paper. Unfortunately, the problem is likely to get worse once other countries in continental Europe begin to grow, putting further upward pressure on world commodity prices and increasing the demand for Norway's exports. Ultimately, the real exchange will have to respond – either through an appreciation of the nominal exchange rate or a jump in domestic inflation. Of the two remedies, the former is clearly the more desirable.

Long-run policy challenges

Even if Norway escapes the latest situation unscathed, long-run policy problems are likely to emerge and will have to be addressed. The most obvious issue relates to Norway's questionable suitability for a fixed, or quasi-fixed, currency arrangement with its European neighbours. As an important energy exporter and producer of other industrial materials, optimum currency area considerations would suggest that a flexible currency arrangement would be more appropriate. Indeed, research conducted by the Bank of Canada, comparing the experience of different economic regions and countries in Europe and North America, has indicated that Norway is one of the least likely candidates for a fixed exchange rate in all of Europe.[1] As Table 1 shows, the correlation between supply shocks and demand shocks in Norway with those in Europe is essentially zero.

These empirical results, based on impulse responses and variance decompositions extracted from structural VARs, must be interpreted with caution. Moreover, they only focus on one dimension of the optimum currency area debate (though admittedly an important one).

[1] See also, Bayoumi and Eichengreen (1994).

Table 1
Variance decomposition of structural shocks –
European model with 13 countries

Countries	Relative contribution of common component (%)	
	Supply shocks	Real demand shocks
Germany	51	51
France	12	22
United Kingdom	18	13
Italy	5*	5*
Spain	25	12
Netherlands	13	26
Belgium	14	20
Switzerland	44	37
Austria	12	11
Sweden	1*	4*
Norway	0*	0*
Portugal	5*	28
Greece	7*	0*

* Shocks that are not statistically related to the common component (5% significance level).
Source: Chamie, DeSerres and Lalonde (1994).

Nevertheless, they do suggest that, from a macro stabilization perspective, a common currency arrangement could pose a problem for Norway. The challenge for the Norwegian authorities, however, would appear to go beyond the question of fixed versus flexible exchange rates. Broader issues of policy assignment and transparency should probably be reviewed as well.

As noted above, and in the text of the paper, Norwegian policy is presently based on the following assignment of macroeconomic tools: (1) monetary policy is effectively charged with stabilizing the exchange rate; (2) fiscal policy is responsible for the long-run management of public resources *and* for moderating short-run fluctuations in the real economy; (3) the Solidarity Alternative is used to ensure domestic price and wage discipline and thereby preserve external competitiveness.

This matching of tools and targets would appear to be ill-suited to the needs of the Norwegian economy and at odds with the comparative advantage of the various instruments even in more benign circumstances.

More specifically, a fixed currency arrangement, as described earlier, would limit, if not vitiate, monetary policy independence and risk destabilizing the domestic economy. Fiscal policy is expected to fine-tune the economy while bearing responsibility for the longer-term financial health of the public sector. Finally, an incomes policy is expected to compensate for the restrictions inherent in a fixed exchange rate by containing wage and price pressures, maintaining the competitiveness of the tradeable goods sector and assisting in the re-equilibration process.

Independent of the target that is ultimately selected for monetary policy, there may be some advantage to adopting a more transparent policy framework, with a clear objective, greater central bank independence and increased accountability. At present, Norges Bank seems to operate under somewhat opaque and conflicting guidelines, which may complicate the process of policy implementation and lead to unnecessary confusion on the part of private agents regarding the intentions of the monetary policy authorities. The Royal Decree requires the Bank to stabilize the value of the krone, but does not specify which currencies are being targeted, how wide the target band should be, how long the exchange rate should be allowed to deviate from its desired level, or what the desired level of the exchange rate is. Greater clarity, both with regard to the long-term objectives of monetary policy and to the short-term operating strategies of the Bank would help condition market expectations and promote better performance. Ideally, this would be combined with greater independence on the part of the central bank and a greater willingness to see the exchange rate move. Absent a flexible exchange rate, however, independence has very little meaning.

Canada has operated under a flexible exchange rate system for most of the post-war period. Our preference for a flexible system is based, in part, on a belief that exchange rate movements are generally driven by market fundamentals, as opposed to destabilizing speculators, and that the costs associated with any short-term volatility in exchange rates and interest rates are relatively minor compared to the larger problems posed by excessively rigid exchange rates, misaligned relative prices, and an astricted adjustment process. In place of a nominal exchange rate anchor for monetary policy, we have opted for an explicit inflation target, with publicly announced inflation target bands and a joint commitment by the government and the central bank to work toward long-run price stability. The latter is regarded as the most important, and perhaps only,

contribution that monetary policy can make to output growth and improved economic performance.

As an open economy, sensitive to movements in world commodity prices, Canada has valued the insulation and automatic adjustment features of a flexible exchange rate, as well as the monetary policy independence that it has provided. Common currencies offer potentially significant microeconomic benefits in the form of reduced uncertainty and lower transactions costs. But these must be weighed against the macroeconomic disadvantages associated with a fixed nominal exchange rate. The policy assignment and institutional arrangements in Norway seem to be predicated on a fundamental suspicion of financial markets and an aversion to relative price movements.

Some recommendations

Three major policy recommendations can be drawn from the previous analysis. First, Norway should consider moving to a flexible exchange rate system. Second, monetary policy should be directed towards price stability with clearly established inflation targets and a transparent framework for policy implementation. Third, fiscal policy should be set on a sustainable medium-term track and shifted away from fine-tuning and other short-term assignments.

I realize that there is nothing very novel or innovative in any of these prescriptions. That does not mean they are wrong (although they may seem rather doctrinaire and obvious). I suspect, however, that nothing that I have said would come as a surprise to the monetary authorities at Norges Bank nor meet with any violent disagreement. The concerns and policy prescriptions that I have identified, are also noted (or at least hinted at) in Qvigstad and Nicolaisen's text, and, in my view, are well founded. While I am not sure that they would be greeted with the same enthusiasm by the Norwegian government, this is a difference in attitude that is shared with many other countries.

I would like to thank the BIS for inviting me to participate in this conference and to the Norwegian authorities for indulging me. I will end where I began, congratulating our Norwegian colleagues for the fine performance of their economy – despite the challenges mentioned earlier – and wishing them all the best in the period ahead.

References

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