Svein Gjedrem: Making use of the central bank

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at Norges Bank's Symposium "What is a useful central bank?", Oslo, 17 November 2010.

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The text below may differ from the actual presentation.

In his first year as governor of Norges Bank in 1985, Hermod Skånland gave a speech entitled: "Making use of the central bank".[1]

Skånland compared the independence of the Bundesbank with Norges Bank's position in the government administration under the credit rationing policy of the time here in Norway. He said: *"In Norway, where no great degree of power has been given to the central bank, it must develop other qualities."* The Bank was to be efficient in its operations and function as a sound adviser for the government authorities.

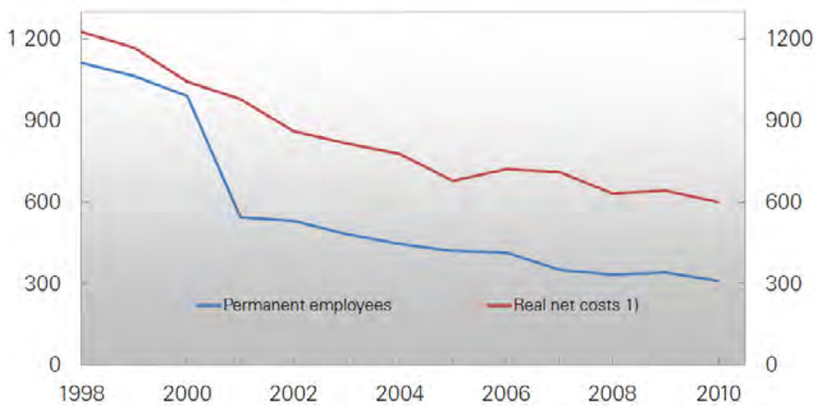
But in the course of Skånland's years as governor, Norges Bank's role changed – the interest rate once again became an active monetary policy instrument.

The Norges Bank of today is a result of its own and the country's economic history. Although the Bank's role is influenced by central bank developments in other countries, we also have our own legal traditions and our own way of organising government administration. The tasks assigned to the Bank are also supported by modern economic theory.

A central bank is different from other public bodies in that it has its own balance sheet, independent budgetary authority and its own accounts. To build confidence in the Bank over time, the central bank must manage this form of autonomy in a sound manner. I have emphasised the importance of an efficiently run central bank that concentrates on core tasks.

Over the past 10–12 years, the number of central banking staff in Norges Bank has been reduced from 1200 to 300 (see Chart 1). This is an adequate staff level. We no longer produce statistics, and we are no longer a manufacturing enterprise. We issue the currency, but we do not print banknotes or mint coins. The distribution of money has been taken over by private business.

Chart 1 Developments in costs and permanent employees excluding Norges Bank Investment Management. In billions of NOK and number of permanent employees. 1998 - 2010



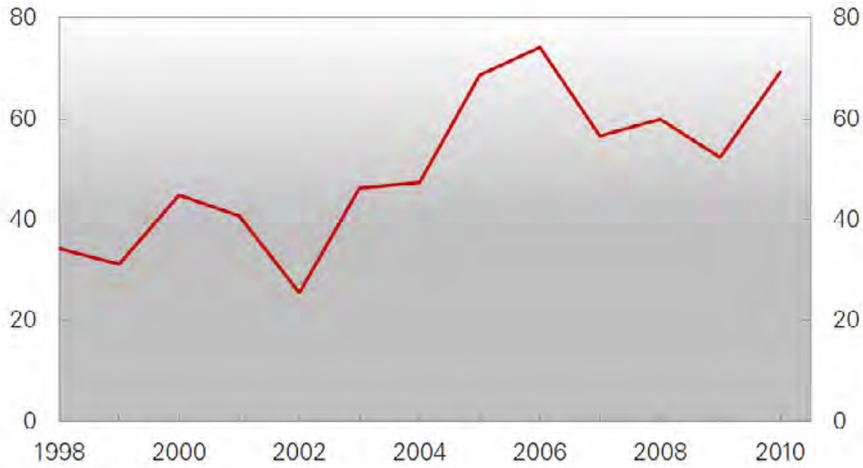
1) Deflated by price index for public expenditure
Source: Norges Bank

[1] Lecture at Norwegian Polytechnic Society, Oslo 17 September 1985. Published in *Economic Bulletin* No. 3, 1985.

As a result, we have been able to reduce the Bank's operating costs by about NOK 600 million per year, measured at constant prices.

At the same time, the Bank's equity capital has increased more than twofold and now stands at close to NOK 70 billion (see Chart 2). The central bank's formal independence must be supported by a solid capital base.[2]

Chart 2 Norges Bank's equity
In billions of NOK. 1998 - 2010[1)]



1) Figures for 2010 are as at 31 October
Source: Norges Bank

The objectives pursued by the central bank are for the common good. The objective of monetary policy has always been determined by the government and the Storting (Norwegian parliament) and was for a long period set out in an Act. Norges Bank has issued notes and coin throughout its history, for the first hundred years based on the silver or gold standard.

However, Norges Bank's tasks have otherwise varied over time.

We manage the Norwegian oil fund, which was a natural step in light of Norges Bank's management of foreign exchange reserves. The fund will not, however, be one of the topics of my speech today.[3]

The origins of Norges Bank

Norges Bank was established in 1816 as a limited liability company, privately owned but under the control of the Storting. It was Norway's first bank. The Napoleonic Wars had been costly for Denmark and eventually led to hyperinflation. In order to secure confidence in the new specie daler, Norges Bank had to be independent.[4] The intention was to make it difficult

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[2] A. Cukierman (2008), "Central Bank Independence and Monetary Policymaking Institutions – Past, Present and Future", *European Journal of Political Economy*, 24 pp 722–36.

[3] For a discussion of the Government Pension Fund Global, see Gjedrem (2010): "Perspectives on managing the Government Pension Fund Global", lecture at the Norwegian Polytechnic Society, 2 November 2010.

[4] See also Carsten Smith (1980):"Bankrett og statsstyre" [Banking law and public governance], p. 39: *"Det klassiske system internasjonalt sett har vært å knytte penge- og kredittpolitikken til en selvstendig stillet sentralbank* [The classic system internationally has been to assign monetary and credit policy to an independent central bank]*."* Universitetsforlaget.

for the government and the Storting to influence the central bank. The Bank's headquarters were located in Trondheim, a 12-day journey from the capital.[5]

The Bank's tasks were to issue Norwegian notes and coin with a stable value measured in silver, perform banking services for the government, provide loans and take deposits. Equity capital was procured by introducing a silver tax. The silver standard was replaced by the gold standard in 1874, and the following year saw Norway's entry into the Scandinavian Currency Union. The Norwegian krone became the new currency unit.

Norges Bank as the bankers' bank

Norges Bank became a more modern institution with the Act of 1892.[6] It became a bank for the banks that had emerged and a common national discount rate was introduced.

The note issuing rules were also changed to enable Norges Bank to meet bank demand for liquidity more easily. It was legally established that Norges Bank would be the government's treasurer.

The Bank remained legally independent of the government authorities in its use of instruments: the Act of 1892 reconfirmed that Norges Bank could not be given instructions by the government or the Storting and Bank decisions could not be reversed by other authorities. The contemporary ideal was an independent central bank.[7]

At the same time, a permanent chair and deputy chair were assigned to Norges Bank's board, both appointed by the government. The other board members were appointed by the Storting, as were the members of the Supervisory Council who were responsible for supervising the Bank. It would seem that the need to distinguish between different roles was not very firmly rooted: the first permanent chair of the board, director Karl Gether Bomhoff, was also a parliamentary representative.[8] He was, by the way, one of Henrik Ibsen's few friends.[9]

In 1897 the Storting had enough confidence in the independence of the central bank to relocate Norges Bank's head office to Kristiania (now Oslo). Payment by cheque was introduced in Norway in the same year, and from 1898 Norges Bank functioned as settlement bank for payments between private banks.[10]

The more flexible note issuing rules proved very useful during the Kristiania crisis in 1899. The crisis followed a housing and construction bubble in the capital. This was the first time the central bank acted as lender of last resort for the banks.

Boom, banking crisis and parity policy

The fairly stable years that then followed after the turn of the century came to an abrupt end with the outbreak of World War I.

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5 Lars Fredrik Øksendal (2008): "Trondhjem som hovedsete for Norges Bank – noen faktiske og kontrafaktiske betraktninger" [Trondheim as Norges Bank's headquarters – some factual and counterfactual considerations], Staff Memo 2008/8, Norges Bank.

6 See Oskar Jæger (1894): "Udsigt over de forandringer, som Norges banks virksomhet har undergaaet ved den nye banklov" [Changes in Norges Bank's operations as a result of the new Norges Bank Act]. *Statsøkonomisk tidsskrift*.

7 Gunhild Ecklund (2008): "Creating a new role for an old central bank: The Bank of Norway 1945–1954." Series of Dissertations 2/2008, BI Norwegian School of Management.

8 There was one parliamentary representative on the board as late as 1983.

9 Ivo de Figueiredo (2007): *Henrik Ibsen. Masken* [Henrik Ibsen. The Mask], Aschehoug.

10 See Harald Haare (2007): "Clearing and settlement at Norges Bank – a historical review", *Economic Bulletin* 4/2007.

Norges Bank's obligation to convert banknotes into gold was suspended, and the central bank provided funding for increased government activities and other purposes.[11] The gold standard ideal of an independent central bank was abandoned during the war. There was strong credit growth. The discount rate was kept low and there was a surge in government spending, while prices for our exports soared and foreign inflows of gold were substantial. The combination resulted in a boom period followed by a stock market crash, a banking crisis and a fall in monetary value.

Francis Sejersted wrote the following about the appointment of Nicolai Rygg as governor of Norges Bank in 1920: *"When [Prime Minister] Gunnar Knudsen [in 1920] called Rygg to the position of chairman of Norges Bank's board, his aim was to secure the services of a strong and knowledgeable man. Gunnar Knudsen suspected an economic storm was brewing, and he suspected something that to a great extent was his own responsibility, namely that monetary policy had been neglected during the war. It is important to keep this in mind in any judgement of Rygg – that he took over an estate that had fallen into grave disrepair. The monetary and fiscal policy pursued during World War I had been lax to a degree that was completely unnecessary".*[12]

Norges Bank now aimed to raise the value of the Norwegian krone and lower the price of gold by means of so-called "parity policy". This line of approach was followed by most advanced economies to restore pre-war exchange rates. A system of stable and convertible currencies was regarded as essential to growth in global trade.

Rygg moreover regarded restoring the value of the krone to its former gold parity as a moral obligation.[13] The Norwegian government held substantial debt in sterling and US dollars and he felt it was important to settle Norway's debts in money of the same value as previously. The same applied to small depositors – they were to feel secure that their money would keep its value over time.[14]

But the central bank also had a banking crisis to deal with. Funding was supplied, partly by Norges Bank and partly by the Treasury, to keep the banks afloat. It took time to restore confidence in the krone and for parity policy to be effective. It was not until May 1928 that the krone was pegged to gold at par.

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[11] For an overview of legislative amendments in connection with World War I, see Carsten Smith (1980): *Bankrett og statsstyre* [Banking law and public governance.

[12] Francis Sejersted (1973): *Ideal, teori og virkelighet. Nicolai Rygg og pengepolitikken i 1920-årene* [Ideals, theory and reality. Nicolai Rygg and monetary policy in the 1920s]. J.W. Cappelens forlag.

[13] In their book *Norsk økonomi i det 20. århundre* [The Norwegian economy in the 20th century], Fritz Hodne and Ola Honningdal Grytten refer to a lecture given by Gustav Cassel, a Swedish economist of international renown, at the Federation of Norwegian Industries on 23 November 1923, where Cassel argued that in Norway's case a devaluation might be an advantage. This offended Rygg, who reminded Cassel that Norway had trodden a difficult path before, and could do so again. Just before he took office, Rygg had written a book about the history of Norges Bank 1816–1916 and had the years 1822–1842 in mind, when 20 years of deflation had been needed to bring the speciedaler back to its former gold parity. He wrote: "*The [monetary] regime is anchored in our legal system, which must be respected. Inherent therein is a moral obligation to restore the monetary system to its previous condition. I know the road ahead of us is long, but I would for my part emphasise that we will follow that road."* From the newspaper article: "Veien og viljen. Et spørsmaal, hvor nordmænd alene har ansvaret. Av direktør N. Ryggs svar til professor Cassel" [The way and the will. An issue for which Norwegians alone are responsible. On Director Rygg's response to Professor Cassel]. See also: Wilhelm Keilhau (1952): *Den norske pengehistorie,* [Norwegian monetary history] Aschehoug for a review of the discussion between Rygg and Cassel.

[14] At that time, small savings played a key welfare function in society. See Francis Sejersted (1973): *Ideal, teori og virkelighet. Nicolai Rygg og pengepolitikken i 1920-årene.* [Ideals, theory and reality. Nicolai Rygg and monetary policy in the 1920s]. Cappelen.

The government and the Storting left much of the responsibility for economic policy to Norges Bank.[15] The recommendation by the Standing Committee on Finance and Economic Affairs in the central bank's annual report for 1924 reads as follows: *"The majority finds that it does not possess the necessary knowledge of all the interacting factors which under these difficult circumstances must affect Norges Bank's decisions to be able to perform a critical review of these decisions."* [16]

In Berge Furre's words, there was: *"... general agreement on the goal – the gold krone – from the political right to the political left."* [17]

After the value of the krone had been brought back to gold parity, the international crisis reached Norway. Starting in the US in 1929, it led to falling prices and wealth losses in all the western economies. The gold standard was an important channel of contagion. Uncertainty led to capital flight to countries with substantial gold reserves, such as the US. Countries with small reserves had to maintain a high interest rate to prevent substantial gold outflows. In September 1931, the UK decided to abandon the gold standard. Denmark, Sweden and Norway brought gold redemption to a halt in the same month.

Norges Bank was put to a severe test in the interwar period. Nicolai Rygg's lot was to resolve the problems left by the policy conducted during and just after the war. His approach was on a par with international practice at the time.[18] Although he had his critics, not all the criticism levelled against him would necessarily be regarded as equally well founded today.

The general view of Rygg has become more balanced.[19] But the perception of Rygg and Norges Bank in the interwar years, that subsequently became ingrained, had an impact on the tasks that were later assigned to the central bank. The pendulum swung towards less independence for Norges Bank, since the Bank was held responsible for the recession. This impression prevailed for such a long time that it also came to influence the current Norges Bank Act.

The scepticism was clearly expressed by Kåre Willoch, who was prime minister when the new Act came into effect in 1985: *"[Nicolai Rygg] was held primarily responsible – and*

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15 In 1926, Minister of Finance Holmboe, of the centrist-liberal party Venstre, said: *"It is however a well known fact that wherever governments have assumed authority over the national bank, the outcome has been unfavourable because vested interests have been so considerable and the temptation so strong that it was impossible to resist, and the government has helped itself to the national bank's cash…".* In Francis Sejersted (1973): *Ideal, teori og virkelighet. Nicolai Rygg og pengepolitikken i 1920-årene.* [Ideals, theory and reality. Nicolai Rygg and monetary policy in the 1920s]. J. W. Cappelens forlag.

16 In Francis Sejersted (1973).

17 Berge Furre (Norwegian historian, theologian and politician for the Socialist Left Party), (1999): "Norsk historie 1905–2000: Industrisamfunnet – frå vokstervisse til framtidstvil" [History of Norway 1905–2000: from confidence in growth to doubts about the future], Det Norske Samlaget.

18 For a lively description of the personalities governing the large central banks in the 1920s, see Liaquat Ahamed (2009): *The Lords of Finance. The bankers who broke the world*. Penguin Books.

19 Hermod Skånland writes about the need to hold someone accountable for the hardships of the 1920s: *"The government is usually a good target for criticism, but there is little appeal in firing shots at a government that is no longer in office, and through the 1920s there had been so many governments that no single government stood out as more responsible than others. On the other hand, there had been one central bank governor, who had also been a prominent figure. Nicolai Rygg became the obvious scapegoat, open to attack from both the masses and from historians, without any economists springing to his defence.*

Thus, the myth became established that the economic difficulties of the 1920s were due to parity policy, and that Nicolai Rygg was responsible for them. From there, it was only a short step to a general scepticism towards monetary policy combined with a more specific distrust of central banks and central bank governors." Hermod Skånland (1998): "Mytedannelsen om paripolitikken" (Myth-making about parity policy), Aftenposten 30 May.

virtually solely responsible – for a policy that became a crucial deterrent to central bank independence for generations of economists and politicians – myself included." [20]

The postwar period of coordination and regulatory optimism

Views on economic policy changed considerably from the end of the 1930s. The Bretton Woods system of fixed exchange rates against the US dollar was established, with the US dollar pegged to gold. Both John Maynard Keynes' theories and analytical tools developed by Norwegian economists such as Ragnar Frisch and Trygve Haavelmo generated regulatory optimism, which laid the basis for a new approach to economic planning, for example through the annual national budgets.

Fiscal policy – changes in public spending and taxes – was now regarded as the most important instrument for smoothing economic fluctuations. The use of direct regulation of the economy increased. The role of interest rate policy was toned down considerably.[21] Centralised planning gained ground, with the Ministry of Finance playing a prominent role. As a result, there was also a shift in Norges Bank's responsibilities, with the full agreement of the Bank. In his first annual address in 1946, Governor of Norges Bank Gunnar Jahn said: *"It goes without saying that a bank of issue cannot and should not conduct a policy that is inconsistent with that determined by the Storting and the government."*

Coordination with government policy was formally strengthened in 1949 when the government acquired all the shares in Norges Bank. In addition, the Bank's annual report was to be sent to the Ministry of Finance and no longer directly to the Storting.

Corporatist channels became important, providing some scope for a central bank in search of a mission.

Samarbeidsnemnda (the Cooperation Committee), a body established in 1951, comprised commercial and savings banks, insurance companies, the Ministry of Finance, the Banking Inspectorate and Norges Bank, with the central bank governor as chair.

Erik Brofoss, the head of Norges Bank from 1954, was enthusiastic:

"During discussions about monetary policy and other economic issues, Norges Bank has often found itself in the position of having to find intermediate solutions that could convey the positions adopted by the Ministry of Finance and by private financial institutions. The actual influence Norges Bank has had in this respect both vis-à-vis the Ministry and the private financial institutions extends far beyond its formal statutory authority." [22]

This line of thinking seems very remote to us today.

Regulatory optimism was the hallmark of the 1960s,[23] and with the Act authorising the regulation of monetary and credit conditions of 1965,[24] which was an enabling Act conferring

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[20] Kåre Willoch [1994]: "Hvor uavhengig bør sentralbanken være?" [How independent should the central bank be?], in *Stabilitet og langsiktighet. Festskrift til Hermod Skånland* [Stability and long-termism. Festschrift to Herman Skånland], Aschehoug.

[21] For example, Governor Erik Brofoss later said: "… the impact of the interest rate, which was once virtually the only monetary policy instrument, is now far more limited in scope." In Erik Brufoss (1959): "Sentralbankens statsrettslige og forvaltningsrettslige stilling" (The central bank's position in relation to constitutional and administrative law]. Lecture given on 27 October. Published in *Statsøkonomisk tidskrift* 1960, pp. 1–31.

[22] Erik Brofoss [1959]: "Sentralbankens statsrettslige og forvaltningsrettslige stilling" [The central bank's position in relation to constitutional and administrative law]. Lecture given on 27 October. Published in *Statsøkonomisk tidskrift* 1960, pp 1–31.

[23] Tore Jørgen Hanisch, Espen Søilen and Gunhild Ecklund (1999): *Norsk økonomisk politikk i det 20. århundre. Verdivalg i en åpen økonomi* [Norwegian economic history in the 20th century. Ethical choices in an open economy] Høyskoleforlaget, Kristiansand.

[24] The 1965 Credit Act and the 1950 Act relating to currency control were not repealed in their entirety until 2003.

authority on the government, Norges Bank gradually drifted into an advisory role. Corporatist collaboration receded somewhat into the background and credit policy was integrated into the national budget.[25]

This was probably an all-time low for Norges Bank. The Bank was not allowed to act, while inflation gained momentum.

When Hermod Skånland began working in Norges Bank as deputy governor in 1971, he was warned by his colleagues at the Ministry of Finance. Later, he said: "... *they did not know how right they were to ask their questions. They [had no idea] how little there was to do of any interest in Norges Bank at that time. It had no instruments, no policy tasks and was wholly and exclusively a supervisory body – apart from the few occasions when it served as a consultative body. So I had placed myself on the sideline*, *but I compensated by offering to chair a number of public commissions."* [26]

Governor Knut Getz Wold wrote in 1972 that: *"Norges Bank's position today in relation to the government authorities is not, however, defined by a formal right to make decisions on specific issues, but by its role as advisor …"*. He went on to say: *"Norges Bank has limited direct power. This is as it should be. But it has, and should have, influence. If store is to be set by its word, it must keep abreast of developments at home and abroad. The Storting and the government have the final word. Having said that, Norges Bank will loyally and actively follow up their decisions."* [27]

In 1973, the efforts to develop an economy under strong centralised coordination and control culminated in a proposal to establish an incomes policy council with regulation of wages.[28]

The proposal was logical. It was the last wall in the structure erected after the war. Coordination and regulation were important key words. Other elements were:

- Fiscal policy oriented towards full employment
- Credit regulation within limits specified in a separate credit budget
- Channelling of loans through state banks
- Regulation of capital movements
- Low nominal interest rates stipulated by the government authorities
- A fixed, though adjustable, krone exchange rate
- Use of price regulation
- An active business policy through state ownership and state grants and subsidies

The proposal to establish an incomes policy council did not receive support. Government regulation and coordinated wage regulation became excessive.[29]

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[25] The collaboration between the authorities and bankers' associations did not disappear completely. In the economic policy tightening of 1979 and 1980, the "konsumlånsforståelsen" (consumer loan understanding) played an important role. Banks undertook to reduce lending to households. This led to a marked rise in saving.

[26] In *Økonomisk Rapport Magasin*, 12 January 2002: "Graver Gjedrem sin egen grav?" [Is Gjedrem digging his own grave?].

[27] Knut Getz Wold (1972): "Norges Banks samarbeid med statsmaktene, bankene og utlandet," [Norges Bank's cooperation with government authorities, the banks and bodies abroad],Kristofer Lehmkuhl Lecture, Norges Handelshøyskole 20 September.

[28] See NOU [Official Norwegian Report] 1973:36. Om prisproblemene [On price problems].

[29] See NOU [Official Norwegian Report] 1983:36 Om prisproblemene [On price problems].

Today's economic policy frameworks are partly a reflection of the experiences of the 1970s and 1980s, both in other countries and in Norway.

The Bretton Woods system collapsed when the US deficit-financed the Vietnam War and extensive welfare reforms, while interest rates were kept low. The gold standard had to be abandoned, inflation rose and an oil price shock was triggered. A shortfall in production and unemployment followed in its wake.

Norway imported high inflation, and domestic inflation was also amplified by galloping wages and a series of krone devaluations.

High inflation undermined the regulation of the credit market. We had had a low nominal interest rate for a long period – several decades – but inflation had also been moderate. From the end of the 1960s, this changed. The real interest rate became highly negative. In addition, galloping wages drove incomes into higher tax brackets, resulting in higher marginal taxation, and the after-tax real interest rate became even more negative. The regulation of credit was not able to stem the tide of credit demand that ensued.

The Norwegian money market became more closely integrated with a growing Eurodollar market at that time. This was partly because oil companies had to exchange their US dollar revenues into NOK for tax payment purposes.

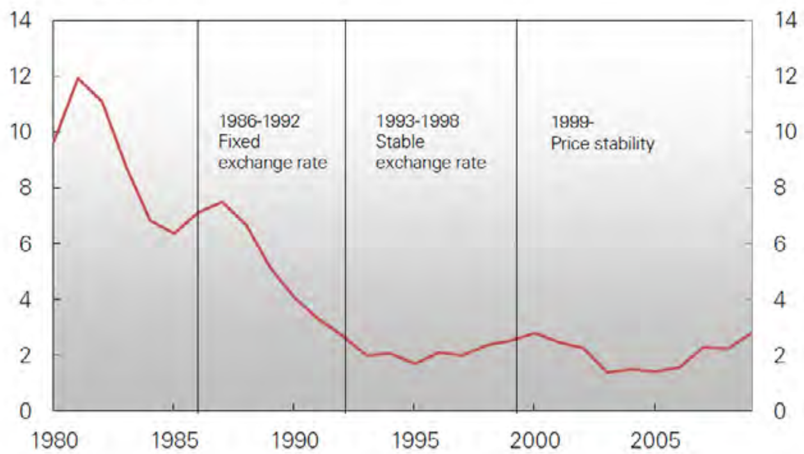
The regulatory regime was imploding.

The interest rate regains its role as a policy instrument

After the drop in oil prices and the last devaluation of the krone in 1986, the interest rate had to be set to support our currency. The alternative was further devaluations, high inflation and economic instability. With a binding commitment to a fixed exchange rate policy from early summer 1986, interest rate setting was largely shifted to Norges Bank.[30]

High inflation is associated with substantial real economic costs. This came into evidence when we managed to bring inflation under control again in Norway at the end of the 1980s. The fixed exchange rate policy was crucial in this context (see Chart 3).

Chart 3 Inflation. 3-year centred average in CPI. Per cent. 1980 – 2009[1)]



1) The projection in MPR 3/10 applied for 2010
Sources: Statistics Norway and Norges Bank

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[30] Hermod Skånland dates this to December 1986 (see Skånland (2005)): "Tilbakeblikk på 20 år med ny sentralbanklov" ["A 20 year retrospective on the new Norges Bank Act"], *Penger og Kreditt* 3/05 (Norwegian only). In my opinion, this shift occurred earlier.

Perhaps we can say that the pendulum had swung back from the view that prevailed in the early years after the war. At that time, it was not Norges Bank, but on the contrary fiscal policy and the detailed regulatory system that had failed. Norges Bank had to be given a greater role again in promoting a well functioning economy.

Later, it would transpire that having brought inflation under control and a series of far-reaching structural reforms in the 1980s and early 1990s, would pave the way for two golden decades in the Norwegian economy.

Throughout the 1990s, the objective of monetary policy was to stabilise the krone and thereby make a contribution to low inflation. The central government budget was to smooth fluctuations in output and employment. This became increasingly demanding as favourable economic developments and oil revenues generated government surpluses. Both the interest rate and the government budget had then, in periods, the effect of amplifying, not dampening, cyclical developments. This resulted in fluctuations in the krone exchange rate.[31]

Norges Bank was forced to recognise that it could not fine tune the exchange rate from day to day or month to month. Nor would the Bank knowingly contribute to fuelling inflation or deflationary downturns. Interest rate policy was then instead geared to keeping inflation in line with euro area countries. As from 1999, the Bank's policy was in practice oriented towards an inflation rate of around 2 per cent.[32] Keeping inflation low and stable is the best contribution monetary policy can make to economic stability and a stable krone exchange rate.

A formal inflation target – with a target of 2.5 per cent – was introduced in Norway in March 2001. The new monetary policy framework was introduced at the same time as the government drew up new fiscal policy guidelines that provided for a gradual, albeit sustainable, phasing in of oil revenues into the Norwegian economy.

Independence in the use of instruments – a premise for stability of the value of money

A number of considerations weigh in favour of setting objectives and delegating tasks to government institutions. This can ease the central authorities' workload. The central government can also seek to ensure that government agencies fulfil their responsibilities by giving them clear objectives and instruments. Furthermore, clear objectives and delegation of tasks may enhance predictability for other economic agents.

In economic policy it is commonly argued that certain long-term objectives can be achieved only if short-term considerations are not allowed to influence the use of policy instruments.[33] This is the case for monetary policy and inflation targeting.[34] There may be a desire to achieve higher, yet unsustainable, growth in output and employment through a low interest rate. But economic agents are aware of this temptation. If they cannot be confident that the key rate is set to ensure stable inflation, they will expect higher inflation over time. The

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[31] Kjell Storvik, Governor of Norges Bank from 1994 to1999, stated in a lecture at FOREX NORWAY on 28 August 1998: *"I would point to the well-known fact that a lower krone exchange rate may contribute to fuelling inflation expectations and that such expectations may in turn generate expectations of a weakening of the krone exchange rate, thereby reinforcing depreciation pressures. Price expectations may thus prove to be a self-fulfilling prophecy. The interest rate level which has now been established should, in addition to directly contributing to stabilising the krone exchange rate, dampen price expectations."*

[32] Svein Gedrem (1999) "Utfordringer i pengepolitikken" [Monetary policy challenges], Aftenposten, 4 May.

[33] Kydland, Finn E. and Prescott, Edward C. (1977): "Rules Rather than Discretion: The Inconsistency of Optimal Plans." *Journal of Political Economy* No. 87, pp 473–492.

[34] Barro, Robert J. and David B. Gordon (1983): "A Positive Theory of Monetary Policy in a Natural Rate Model", *Journal of Political Economy* No. 12 pp. 101–121.

long-term cost can be considerable and the short-term gains limited. Norway and other countries learned this in the 1970s and 1980s.

The British prime minister Harold Wilson once remarked, “A week is a long time in politics”. This attitude also influenced economic policy in our country. The result was economic instability, with both high inflation and high unemployment. Just as Ulysses had himself tied to the mast to resist the Sirens’[35] temptations, the government authorities can prevent themselves from pursuing a policy that is harmful in the long run by setting objectives and delegating tasks.

A central bank should be independent in its use of policy instruments, though the objective of monetary policy should naturally be set out by the government and the Storting.[36]

The division of responsibility was clearly defined when the government presented its guidelines in 2001.

Since the various elements of economic policy differ in their effects, they have different tasks:

- Monetary policy now steers inflation in the medium and long term and can in addition contribute to smoothing fluctuations in output and employment.
- The central government budget – growth in public expenditure, which must be sustainable in the long term – influences the krone and the size of the internationally exposed sector in the medium term.
- Wage formation and economic structures and incentives provide the basis for efficient use of our labour resources and other economic resources, and for economic growth.

There is also an interaction:

- In their budget resolutions, the government authorities will attach importance to the effects of the budget on the Norwegian economy and will therefore take account of the effect on the interest rate. In this way, they avoid a situation where growth in public expenditure and the interest rate push the economy in different directions.
- With a known monetary policy response pattern, the parties to the centralised income settlements can take into account interest rate effects when wage increases are agreed.
- Moreover, the parties to public sector negotiations can take into account that the higher the pay increases are, the fewer there are who can be remunerated over government budgets.

Norges Bank Act of 1985 – a framework for today’s monetary policy

The Norges Bank Act, passed in 1985, governs monetary policy.[37] The Act was drafted in the light of Norges Bank’s role in the postwar government administration. Therefore, the new Executive Board, which replaced the board of directors under the 1892 Act, is now appointed by the Council of State.

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35 Elster, Jon (1979): *Ulysses and the Sirens. Studies in Rationality and Irrationality,* University Press, Cambridge.

36 Stanley Fischer introduced the difference between goal and instrument independence. See Fischer (1995): “Modern approaches to central banking”, NBER Working Paper No. 5064.

37 The Norges Bank Act is discussed in Helge Syrstad (2003):” Sentralbankens uavhengighet” [Central bank independence], Fagbokforlaget.

Under the Act, Norges Bank is an executive and advisory body for monetary, credit and foreign exchange policy and shall monitor developments in the money, credit and foreign exchange markets.

The Act makes no reference to the objective of monetary policy. On the contrary, its formulations are completely open-ended.[38]

The Bank shall conduct its operations in accordance with the economic policy guidelines drawn up by the government authorities. How this was to be interpreted was the subject of controversy in the first years. Today, in the light of both the text of the Act and of the preparatory works, the implications of this may also be unclear. This provision has not gained any further practical significance. Today, Norges Bank no longer looks for guidelines in public documents. The reason is that the inflation target, which is governed by regulation in pursuance of other provisions of the Act, provides the central bank with a suitable mandate.

The central bank is no longer a limited liability company as it was until 1985, but a separate legal entity owned by the state.

The central bank shall submit matters of *special* importance to the Ministry of Finance before making a decision. Although this submission arrangement gives the Ministry of Finance an opportunity to state its views, and obliges Norges Bank to consider them, it does not relieve Norges Bank of the full responsibility for its decisions.

The text of the Act does not specify which matters are not only important, but of *special* importance. The preparatory works of the Act provide little guidance today. When the Act was under preparation, the interest rate was not a policy instrument, but had the nature of being an end in itself. It was rarely changed, and then only in critical situations for the Norwegian economy. In the period of exchange rate management in the 1990s, changes in the key rate were also linked to large currency inflows or outflows that might indicate substantial imbalances in our economy. In the past 10–12 years this has changed completely. Norges Bank operates a target set by the government authorities, and interest rate changes are nearly always small and rarely come as a surprise to economic agents. While these changes may appear to be important, it would be to inflate the wording to characterise them as matters of *special* importance.

When in more critical situations, such as autumn 2008, a need arises for more pronounced changes in interest rate and liquidity policy, the Bank has without a doubt an obligation to submit the matter to the Ministry.

There must always be a good flow of information from Norges Bank to the Ministry of Finance.

Norges Bank has a special position in public administration. This is expressed, for example, in the instructions section of the Norges Bank Act. While ministries in Norway, in contrast to Sweden for example, can easily issue instructions to their subordinate agencies, this provision sets strict formal requirements for instructing the Bank. This power cannot be delegated by the Council of State to the Ministry of Finance. The Bank shall be consulted in advance and the Storting shall forthwith be notified of the reason for the instruction. Former supreme court justice Carsten Smith has stressed that the Act must be interpreted to mean that this must be set out in a separate report and under full transparency.[39]

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[38] The following is stated on page 3 of the recommendation from the Standing Committee on Finance and Economic Affairs concerning the Act relating to Norges Bank and the Monetary System etc. (Recommendation No. 50 (1984–85) to the Odelsting: "A new Norges Bank Act should be able to be adapted to various scenarios. In line with this, the Committee proposes a general clause for the Bank's activities and that the Council of State be authorised to lay down further guidelines in a number of areas".

[39] Carsten Smith (1992): *Rettstenkning i samtiden* [Contemporary legal thinking], p. 410. Universitetsforlaget.

In its consultation statement on the new Norges Bank bill, the Ministry of Justice through its Legislation Department expressed the view that the right to issue instructions should be in closer keeping with ordinary rules relating to government administration, adding: *"We note for the record our agreement that there are strong arguments for limitations on instructing Norges Bank on the exercise of its authority. From a legal standpoint, however, there should be no doubt that the power to do so exists and that this power should be formulated in a manner which does not make it virtually impossible to exercise it in practice".*

The views of the Legislation Department were not taken into account. The relevant section of the Act was worded in such a way as to make the power to instruct the Bank virtually impossible to exercise in practice. Nor has it ever been applied in individual cases, except when the inflation target was introduced in 2001 after consultations with Norges Bank. Norges Bank has, in Getz Wold's words from 1972, followed up the inflation target loyally and actively.

The instruction section does not prevent Norges Bank from setting the interest rate independently of pressures from the central government authorities. It is difficult to conceive today that this could change. There is therefore hardly a pressing need to remove it. It could still be argued that in international comparisons Norges Bank is less independent than it actually is. On the other hand, it can be argued that Norway could be faced with a perilous situation, such as military conflict, for example, where the central bank itself finds that the government should use its power of instruction with regard to foreign exchange reserves and the central bank's management of monetary and liquidity policy.

In many ways the current Norges Bank Act is a product of 1960s and 1970s economic thinking, but certain adjustments have been made to the Act since 1985. Particularly important is the prohibition against the central bank granting credit to the central government. The practice for appointing members of the Executive Board has also changed. Where the political parties in the Storting once nominated relevant candidates, members are now evaluated independently of party background and appointed by the Council of State upon the recommendation of the Ministry of Finance.

One typical feature of recent central bank legislation in other countries is an objects provision that stipulates the central bank's primary objective as ensuring stability in monetary value. In Norway, this is set out in a statutory regulation and as an operational and more intermediate target. This is an essential difference.

Another feature of central bank legislation in other countries is legal independence, in the sense that the central bank's use of instruments, primarily the key interest rate, cannot be overruled, whether by instruction or reversal.

If the Norges Bank Act were being written today, it would probably include an objects section. As mentioned, much of the preparatory works is out of date so that the provisions of the Act of 1985 must be interpreted in the light of the current economic system. Moreover, Section 1 reads *"[t]he bank may implement any measures customarily or ordinarily taken by a central bank*", and this is something that changes, as we know. The Act is thus flexible enough to provide a suitable framework also for the conduct of monetary policy today. It specifies, moreover, that Norges Banks sets the interest rates on its loans and deposits.

Norges Bank's responsibilities are also now well established through practice.

The central bank is accountable

Norges Bank has two parallel governing bodies. In addition to an Executive Board, appointed by the Council of State, it has a Supervisory Council appointed by the Storting. This is also shows the peculiar position of the Bank in the government administration. The direct link to the country's national assembly reflects that the Storting under Article 75 (c) of the Norwegian Constitution "shall supervise the monetary affairs of the Realm". The Supervisory

Council continues to have a mix of administrative and supervisory duties, but its tasks were delimited by the Act of 1985.[40] The Supervisory Council shall supervise the Bank's activities and ensure that the rules governing the Bank's operations are observed. The council has its own secretariat, adopts the annual accounts of Norges Bank and approves its budget.

The Bank continues in part to be the Storting's bank.

A substantial change has taken place over the past decade in that the Supervisory Council shall no long submit a report on its activities to the Ministry of Finance, but directly to the Storting. This is a partial reversal of the change to the Act that was made in 1949.

In my judgement, the tasks of the Supervisory Council could be broadened. Among other things, it should be able to play a greater role in appointments to the Executive Board and Bank management, for example, through a formal right to make recommendations.[41] This could give the Supervisory Council an even greater sense of ownership over the organisation and strengthen their sense of commitment.

In central banking circles it is easy to confuse independence, expertise and long-termism with infallibility.[42] Central bank independence in the use of instruments is contingent on central bank transparency and disclosure of the background for its decisions. This provides a basis for evaluating the Bank's decisions.

Moreover, the central bank is accountable.

In Norway, the Ministry of Finance performs an annual evaluation of the conduct of monetary policy in a separate report. Its assessment is partly based on a report by an independent expert group. The Governor of Norges Bank appears at a parliamentary hearing when the Standing Committee on Finance and Economic Affairs works on the report. The discussion concludes with a debate in the Storting.

Advisory role

With new and clearly defined economic policy tasks, Norges Bank stepped back somewhat as economic policy advisor. For example, the Bank has discontinued its annual assessment of fiscal policy in what was at the time labelled "budget letters", and we rarely express our views on official reports regarding economic issues.

Norges Bank is a consultative body for laws and regulations affecting the stability of the financial system.[43] Moreover, the Bank is obliged under the Act to inform the Ministry when in the opinion of the Bank, there is a need for measures related to monetary, credit or exchange rate policy to be taken by others than the Bank.

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[40] Helge Syrstad (2003): *Sentralbankens uavhengighet* [Central bank independence], Fagbokforlaget.

[41] In a different context, professor Eivind Smith states another view that may be of importance: *"It can be conceivably argued that independence [..] is possible only if the authority to appoint persons to the "independent" body is delegated to bodies other than those the appointees are supposed to be independent of. For example, a body whose members are appointed by the King would not be "independent" of the King (or the ministry)."* Source: "The constitutional power to delegate decision-making authority to "independent" bodies". Appendix 5 to NOU [Official Norwegian Report] 1997:19: Better privacy protection.

[42] We can refer to Norges Bank's reputation survey. In an otherwise positive report, some respondents were of the view that Norges Bank is closed and somewhat unresponsive. See Press release 24 June 2010.

[43] See Section 3 of the Norges Bank Act.

Financial stability

A challenge for the central bank is that there is a gap between the instruments at the Bank's disposal in the area of financial stability and the existing expectations that the Bank can ensure the stability of the financial system. If liquidity dries up among banks in Norway or abroad, they are certain to turn to the central bank. The central bank acts as lender of last resort, as it can always supply liquidity in Norwegian kroner. Moreover, the central bank holds foreign exchange reserves that can be made available to the banks in critical situations.

But we have no formal competence with regard to financial market regulation and prevention. What we can do is offer advice concerning regulation and set terms for banks' loans from the central bank.

In 1986, Norges Bank provided substantial loans to the banks – at the highest around NOK 80 billion – to prevent a rise in money market rates after large-scale NOK purchases had been made in support of the krone.[44] The loans, which were unsecured, were kept on Norges Bank's balance sheet when solvency problems at the banks began in 1987. Norges Bank was later criticised for providing these loans. Although the criticism was misdirected, the loans did make it more difficult for the government to manage the banking crisis.[45]

Today the Bank no longer provides unsecured loans and we have gradually tightened collateral requirements.

Many banks rely heavily on short-term funding in international and domestic money markets. The lesson from the most recent financial crisis is that a shortfall in foreign funding can weaken stability in the financial system in Norway, even if the banks' financial position is not in jeopardy at the outset. The next step will therefore be not only to require collateral, but also impose requirements on our clients – the banks – to improve their funding strategies. Banks must not be given the scope to take on substantial liquidity risk in the belief or with the certainty that Norges Bank will intervene should foreign funding seize up. A market functions poorly in the long term with such hidden support.

With large unsecured loans, Norges Bank ended up providing income support in one instance in the 1980s when a savings bank experienced solvency problems. The support included a soft loan and the write-down of a loan. The measures were part of a broader bank rescue package. The Ministry of Finance immediately submitted a report to the Storting (Report No. 24 (1989–90) where the Ministry of Finance wrote*"..The write-down of loans from the central bank may […] represent an active use of central government funds that should be deliberated in the Storting in advance".* The Standing Committee on Finance and Economic Affairs endorsed this view and the resolution received final approval only after the Storting had deliberated the matter.

This delimitation of Norges Bank's tasks is important. Norges Bank shall not provide grants or capital to the banks. During the financial crisis in August 2008, the banks' short-term and medium-term funding seized up. Norges Bank provided short-term loans as is customary and natural for a central bank. At the same time, we took the initiative to put in place the swap arrangement, whereby banks could exchange covered bonds (OMFs) for government securities. This went through the government's balance sheet and not that of the central

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44 See Chart 1 in Karsten Gerdrup (2004): "Norges Bank' role in the event of liquidity crises in the financial sector." *Economic Bulletin* no. 2/2005.

45 For a discussion, see Tore Jørgen Hanisch, Espen Søilen and Gunhild Ecklund (1999):"Norsk økonomisk politikk i det 20. århundret. Verdivalg i en åpne økonomi". [Norwegian economic policy and politics in the 20th century. Ethical choices in an open economy], Høyskoleforlaget, and Fritz Hodne and Ola Honningdal Grytten (2002): "Norsk økonomi i det 20. århundret" [The Norwegian economy in the 20th century], Fagbokforlaget.

bank. The central bank did not provide long-term loans on a large scale.[46] This distinguishes the management of the financial crisis in Norway from a number of other countries in that we are of the view that it is appropriate for such medium-term financing – as in the case of solvency support – to be provided by the government and not Norges Bank, if the situation has reached a point where this is necessary.[47] The measure is given a broad democratic grounding through government and Storting deliberations. This approach also serves to counter the kind of criticism that was levelled at Norges Bank when it provided funding for banks in the mid-1980s.

Financial imbalances ordinarily build up over a long period before they trigger a crisis. Internationally, measures intended to prevent systemic risks in the financial sector are usually referred to as macroprudential policy.

The government authorities should primarily use structural measures to dampen self-intensifying forces behind credit growth and rising property prices. The most important measure will be to increase banks' capital requirements.

The international minimum standard for banking regulation will be strengthened under the forthcoming Basel III framework. However, we note that some countries do not wish to subject their banks to stringent standards. These countries' governments are more concerned that their banks have framework conditions at least as favourable as competitors from other countries. This attitude leads to a competition to weaken the requirements as far as possible. The minimum requirements will not be lower than the level all the major countries will agree to.

Given such minimum requirements, there is every reason to set stricter national rules. The Norwegian authorities have been doing this for a number of years, including requiring banks to hold more pure equity than most other countries have done.

Banks object that higher capital standards make it more expensive to operate and will make borrowing more expensive for households and enterprises, in addition to reducing the competitiveness of Norwegian banks. But that a bank should be at a competitive disadvantage if it is not allowed to be as financially weak as another bank is hard to take seriously. This line of thinking presupposes that the government will bail out the banks. But we should not accept this supposition. Higher capital ratios will make banks less risky for shareholders, creditors and the government. Less risk means that banks' creditors will require a lower interest rate.[48]

In addition to higher permanent capital standards and other structural measures, it is also appropriate to use discretionary measures when systemic risk increases above normal.

Under Basel III, higher capital requirements for banks can be required in the event of rising lending growth and surging property prices, see Chart 4. But other measures are also possible. Finanstilsynet (the Financial Supervisory Authority of Norway), for example, sets limits on the size of a single loan in relation to the collateral provided. Another possible measure is to set minimum requirements for the risk weights banks can use in their internal model-based approach to calculating capital adequacy.

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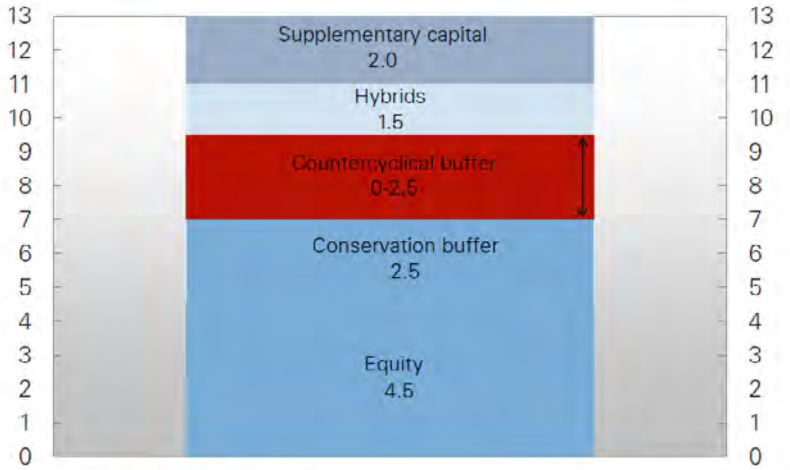
46 As an extraordinary measure, in connection with the establishment of the swap facility, 2- and 3-year fixed-rate loans specially designed for small banks were allotted. This was extensively explained in the Storting documents.

47 See also Peter Stella: "Minimizing Monetary Policy". Paper presented at the Annual General Meeting of the Bank for International Settlements in June 2009. http://www.bis.org/events/conf100624/stellapaper.pdf

48 The mechanism in known in economic theory, see the Modigliani-Miller theorem.

Chart 4 New minimum capital adequacy requirements and new capital buffer requirements. Per cent of risk-weighted assets



Sources: Basel Committee and Norges Bank

In other countries the procedures are now being revised to allow central banks to participate when such discretionary measures are implemented.

In Norway, Finanstilsynet is highly competent in the oversight of individual institutions. However, Norges Bank has more competence in macroeconomic matters, given its tasks. The central bank also has an informational advantage as we are the bankers' bank and operate in foreign and domestic markets. The division of responsibility should be based on the advantages specific to each organisation. The Ministry of Finance should define the objective of macroprudential supervision and delegate its use. The Ministry must also assess whether the objective has been achieved.

One alternative is to delegate responsibility for implementing discretionary measures against systemic risk to Norges Bank. Another is procedural requirements for using Norges Bank's expertise appropriately. The Bank may, for example, have the right and a duty to issue an opinion. Finanstilsynet should in principle have to follow the advice provided by the Bank. If the advice is not followed, an explanation must be provided and made publicly available.

In order to ensure a disciplined decision-making process, the relationship to the other components of economic policy must be clear. Macroprudential supervision must seek to reduce systemic risk and take monetary policy and fiscal policy as a given.

The objective of monetary policy is low and stable inflation and to contribute to dampening fluctuations in output and employment. Monetary policy takes into account that pronounced movements in credit growth and house prices can feed through to inflation and output, but is not geared directly to stabilising the financial system.

Conclusion

Allow me to conclude.

Norges Bank is no longer in search of a role. We no longer take part in corporatist processes. Norges Bank now has a less prominent role as advisor.

We do not believe in economic fine-tuning, but we do have instruments that can ensure low and stable inflation over time.

Macroprudential supervision is now being moulded. Norges Bank must critically evaluate the funding structures of banks that have access to our lending facilities. We must develop instruments that can induce banks to limit their short-term borrowing in domestic and foreign markets.

There is a strong sense at Norges Bank that we are being put to effective use today.

Thank you for your attention.