Ida Wolden Bache: Monetary and fiscal policy in a dynamic world

Speech by Ms Ida Wolden Bache, Governor of Norges Bank (Central Bank of Norway), at the 8th Annual Research Conference of De Nederlandsche Bank, Amsterdam, 11 November 2025.

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Good afternoon and thank you very much for inviting me to this interesting and timely conference. It is a great pleasure to be here.

Norway and the Netherlands share a common experience: the discovery of major natural resources in the 1960s and 1970s. Such discoveries can be transformative, but they also carry risks, as the Netherlands experienced during the 1970s. An increase in natural resource revenues can erode the competitiveness of other industries through currency appreciation and can also fuel rapid growth in public spending.[1] Together, such effects can leave the economy more vulnerable once resources have been depleted.

To address these challenges, Norway set up the Government Pension Fund Global in the 1990s. The fund channels oil and gas revenues into financial assets abroad and is now one of the world's largest sovereign wealth funds. It is managed by Norges Bank under a framework set by the political authorities. While the fund does not play a direct role in monetary policy, it does provide fiscal space, as up to three percent of the value of the fund can be used in the national budget each year. The fund and the fiscal rule help shield the domestic economy from fluctuations in oil prices and ensure a gradual phasing-in of petroleum revenues.

In these brief remarks, I want to make two main points on the interaction between fiscal and monetary policy. First, the past few years have underlined the importance of independent central banks that focus firmly on their mandates. Second, policy mix matters: the optimal combination of fiscal and monetary policy depends on the shocks hitting the economy.

On the first point: the challenges facing central banks have shifted markedly in recent years. In the decade or so prior to the Covid-19 pandemic, inflation was stubbornly low in many countries. Policy rates hit zero or below, and instruments such as forward guidance and quantitative easing were used to compress long-term yields and risk premia. At the same time, policymakers allowed the time horizon for bringing inflation back to target to become more flexible.[2] The prospect of rapidly rising prices seemed remote.

That assumption proved wrong. The surge in prices in 2022 and 2023 forced a rapid tightening of monetary policy across the world. In hindsight, it is clear that both our models and our judgment were shaped by the long period of low inflation. We underestimated how strongly the combination of pandemic-related supply shocks and expansionary policies would fuel inflation.

These last few years monetary policy has gone back to basics: keeping inflation low and stable. This does not mean a return to strict inflation targeting; most central bank mandates also give weight to employment and the real economy. But it does mean that we should make sure that there is no doubt about our determination to bring inflation back to target. History shows that once confidence in price stability is lost, the cost of restoring it can be very high.

Three points follow from this. First, we should be realistic about what monetary policy can and cannot achieve. Monetary policy affects the economy broadly; it cannot be targeted toward specific sectors or groups. Some policy objectives require more targeted measures. For instance, during the Covid-19 pandemic, targeted fiscal support helped the sectors and workers most exposed to shutdowns and weak demand. Another example is climate change. While both the physical effects of climate change and the transition to a low-carbon economy have implications for the economy, and hence for monetary policy, the policy rate is not an effective tool for supporting that transition. Emission reductions are better achieved through targeted measures such as quotas and taxes.

Second, central banks must communicate clearly how we respond to shocks – what Philip Lane has called "reaction function guidance".[3] We should explain the reasoning behind our decisions and how they are affected by new information. In Norway, we publish a policy rate forecast that is consistent with our forecasts of other variables. We also describe how new information has affected the rate forecast. Importantly, the rate path is not a promise, and indeed it has been adjusted substantially in recent years as the outlook has changed. We nevertheless believe that it remains a useful communication tool that also makes it easier for the public to evaluate our performance.

Third, we must recognise the importance of maintaining broad public support for how we conduct policy. Over the past few years, many central banks have updated their monetary policy strategies to reflect new challenges. And in some countries, monetary policy mandates are reviewed regularly. Earlier this year, the government initiated such a process in Norway. Regular reviews provide an opportunity to take on board new insights and strengthen democratic support for independent monetary policy. While I will not pre-empt any conclusions of the government's review, let me just say that the mandate for monetary policy should be flexible enough to address different types of disturbances – not only those that have occurred in the recent past. But the mandate should also be sufficiently precise to allow others to hold us to account.

Now let me get to my second point on policy mix. While it is important to safeguard the independence of monetary policy, we should also recognise that fiscal and monetary policy play complementary roles in stabilising the economy in response to shocks. In many situations, they should pull in the same direction. For example, a positive demand shock would typically call for tighter monetary policy and a more restrictive fiscal stance. But there may also be situations when the two policy instruments should not pull in the same direction. Such situations may arise in small, open economies such as Norway, where monetary policy not only operates through the aggregate demand channel, but also influences inflation by affecting the exchange rate. Suppose for instance that the economy is hit by an inflation shock that simultaneously weakens output and employment. An expansionary fiscal policy could then help support employment while tighter monetary policy could dampen imported inflation by strengthening the exchange rate. Under some conditions, this mix may deliver a better balance between stabilising inflation and output, particularly if fiscal measures are well targeted.[4]

The broader lesson is simple: monetary policy remains the primary instrument for price stability, but the appropriate policy mix depends on the shock. Clear communication from central banks may help fiscal authorities take the monetary policy reaction function into account when formulating policy.

Let me end where I began: with institutions and vulnerabilities. Over time, Norway's oil revenues have generated large government surpluses. Fiscal dominance is not an immediate threat to monetary policy independence in Norway. But that does not mean that we do not face risks. First, as around one quarter of government spending is now financed by transfers from the sovereign wealth fund, a sharp and lasting fall in global equity markets could necessitate significant fiscal tightening. Second, while public debt is low, Norwegian *households* are among the most indebted in the world – another thing we have in common with the Netherlands. A rise in lending rates or a fall in house prices can prompt households to cut consumption sharply. That can weaken firms' earnings and debt-servicing capacity, and potentially amplify downturns through the banking system.

These are not imminent threats. But they do remind us that sound public finances do not make us immune to shocks. They also underline the importance of strong policy frameworks that enable us to respond effectively to shocks. A credible and transparent monetary policy is the first line of defense for securing price stability. That has always mattered. In a world of higher geopolitical risk, structural change and new kinds of shocks, it matters even more.

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[1] See for instance Harding, T., R. Stefanski and G. Toews (2020) "Boom Goes the Price: Giant Resource Discoveries and Real Exchange Rate Appreciation". *The Economic Journal*, 130 (630), pages 1715-1728 and Kazimov, K., K. Hamilton and R. Arezki (2011) "Resource Windfalls, Macroeconomic Stability and Growth: The Role of Political Institutions". *IMF Working Paper* 2011/142.

[2] Borio, C. and M. Chavaz (2025) "Moving targets? Inflation targeting frameworks, 1990-2025". *BIS Quarterly Review* March 2025. Bank for International Settlements.

[3] Lane, P. R (2025). *The communication of monetary policy decisions: incorporating risks and uncertainty*. Washington D.C., 16 May. European Central Bank.

[4] Bergholt, D., Ø. Røisland, T. Sveen and R. Torvik (2025) "Should monetary and fiscal policy pull in the same direction?". *Norges Bank Working Paper* 8/2025.