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On keeping promises

A collection of articles based on three lectures given at a seminar arranged by Norges Bank and the Norwegian Academy of Science and Letters on 11 November 2008

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On keeping promises

A collection of articles based on three lectures given at a seminar arranged by Norges Bank and the Norwegian Academy of Science and Letters on 11 November 2008.

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Introduction

by Rune Slagstad[*]

A seminar entitled "On keeping promises" was hosted by Norges Bank and the Norwegian Academy of Science and Letters on 11 November 2008. In modern political science, this topic has been analysed as the "Odysseus motive" in Jon Elster's seminal work *Ulysses and the Sirens* (1979): Odysseus let himself be bound to the mast to prevent him from being seduced by the song of the sirens. Elster's theory has inspired Francis Sejersted in his interpretation of the Norwegian state as a constitutional democracy, with predictability as an essential element. In his introduction, Deputy Governor Jan F. Qvigstad discusses the dilemmas facing monetary policy from the same perspective. Qvigstad's lecture and commentaries by Endre Stavang and Henrik Syse are included here, followed by Francis Sejersted's concluding remarks on the dilemmas of binding.

[*] Rune Slagstad is professor at Oslo University College and senior researcher at the Institute for Social Research (ISF). He is also editor of *Nytt Norsk Tidsskrift.*

On keeping promises

by Jan F. Qvigstad[*]

Why is keeping promises so difficult?

This house, which now belongs to the Norwegian Academy of Science and Letters, was built by Hans Rasmus Astrup in 1886-87. Astrup was an entrepreneur. At the age of 20, he left Norway for Barcelona on a ship laden with a cargo of dried cod. He gradually built up a large trading business and later became an industrialist, not unlike businessmen of our own era.[1]

For innovators and the business sector, a stable operating environment has always been important, providing a foundation for adaptation, economic growth and social progress. A stable value of money is also a component of this foundation.

We were taught as children to keep our promises. If we made a promise, we had to make good on it. But we were also taught that we should not promise too much. If we do not keep our word, others lose confidence in us and our credibility takes a toll. In recent months, we have witnessed that this is of particular importance for the financial system. A proximate example is the situation in our neighbouring country Iceland.

The value of confidence and credibility has been the subject of extensive analysis in many fields, including jurisprudence and the social sciences. And the conclusion is clear – progress can be achieved if promises are kept.

If keeping promises is clearly beneficial, why is it then so difficult? The expressions empty promises and empty threats reflect the temptation to renege. The social scientist and philosopher Jon Elster writes in his book *Ulysses and the Sirens*[2] about weakness of will, shifting preferences over time, and the complexities of human nature. This is familiar ground. As early as 1960, the economist Thomas Schelling[3] discussed similar issues in analyses for which he was awarded the Nobel Prize in economics. According to Schelling, a credible threat can be difficult to establish when realising the threat involves costs for all the parties involved. A promise or a threat will be more credible if the promisor lets himself be bound to the mast.

Two other economists carried out groundbreaking work when they applied Schelling's analysis

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[*] Jan F. Qvigstad is deputy governor of Norges Bank. Ragna Alstadheim has provided valuable assistance in preparing this article.

[1] See Reidar Sevåg (1967): *Statsråd H. R. Astrup*, Oslo: Dreyer.

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

[3] Thomas C. Schelling (1960): *The Strategy of Conflict,* Cambridge, Mass. and London: Harvard University Press.

to economic issues. In 1977, Finn Kydland from Norway and Edward Prescott[4] from the US wrote an article showing that authorities who attempt to follow an optimal economic policy plan may have strong incentives to depart from the same plan at a later time.[5] This applies even if no news has emerged to indicate that the plan should be changed. Kydland and Prescott were later awarded the Nobel Prize in economics for their work.

There is a common denominator between Elster, Schelling, Kydland and Prescott: keeping a promise is difficult, because reneging on a promise will often be the tempting or rational choice in the short-term. If loss of credibility is taken into account, the best solution in the long term will nonetheless often be to keep your word.

A key issue is how we can establish mechanisms that also safeguard long-term objectives in the short term. Jon Elster suggested the metaphor of "binding oneself to the mast". We all know the myth of Ulysses and the sirens, referred to in Elster's work. Ulysses wanted to hear the song of the sirens, but he knew that he and his crew would then come under the sirens' spell, bringing their voyage to an end. He therefore ordered the crew to bind him to the mast, but before they did so, he filled their ears with wax. This prevented him from steering the ship towards the sirens himself, and the crew were prevented from hearing him when he would later succumb to temptation and order the ship to be steered towards the sirens' island. The story cannot be directly transferred to economic management, but the concept of "binding oneself to the mast" is used to describe mechanisms that prevent short-term objectives from taking precedence over long-term objectives. Precluding the possibility of breaking a promise makes the promise more credible. Ensuring accountability for promises made through reporting and review can be a mechanism that binds us to the mast.

A central bank's most important task is to ensure a stable value of money. The value of money relies on responsible economic policies. For a central bank to be able to keep its promise and deliver a stable value of money, it must have the backing of the political authorities. Otherwise, the central bank will not be able to keep its promise.

In the long term, the instruments available to the central bank allow it to deliver only the promise of a stable value of money. Earlier, this promise was kept by regulating the amount of money issued. Today, the instrument is the interest rate. The central bank cannot steer real wages, the labour supply, employment or the level of unemployment in the long term. But it can contribute to curbing short-term cyclical fluctuations if price stability is firmly anchored.

Throughout history central banks have attempted to bind themselves to the mast in different ways. In the following, I will discuss the temptations facing issuers of notes and coins, the

[4] Finn E. Kydland and Edward C. Prescott (1977): "Rules Rather Than Discretion: The Inconsistency of Optimal Plans" in *Journal of Political Economy*, 85, No. 3, pp. 473-491.

[5] In macroeconomics, this dilemma is called the time inconsistency problem.

binding mechanisms that have been tested, and the potential gains for society of a central bank that keeps its promises.

A king's word is worth a throne – but sometimes not a krone

It has always been tempting for issuers of money to exploit this privilege. It costs less to produce a coin or a banknote than the value printed on it. The added value accruing to the issuer is called seignorage.

Over-issuance of notes and coins leads to inflation and a fall in the value of money, and holders of money pay a so-called inflation tax. A sharp fall or strong rise in the value of money also impairs the functioning of the economy because it becomes more difficult to keep track of changes in the price of one good relative to another. It is important that changes in relative prices are easy to observe for both consumers and producers. Otherwise, the function of prices as conveyors of information for consumption, production and investment decisions will be impaired. The economy will operate less efficiently, resulting in lower growth and welfare.

In the earliest monetary systems, the value of money corresponded to the metal value of the coin. Measured in metal, the value of money was inevitably stable. This system was not as dependent on confidence since the metal content of the coin could in principle be verified at every transaction.

Those in power nevertheless managed to exploit the system. Roman emperors were in the habit of financing their wars by reducing the precious metal content of their coins. This resulted in higher seignorage revenues from each coin issued. For a period, these revenues were sufficient to finance an army, a long war or several monuments. This is the number one temptation facing money issuers.

Henry VIII of England was one of the most renowned exponents of this kind of behaviour[6]. In the 1500s, he reduced the silver content in coins to one third of the original to finance wars against France and his own expensive lifestyle.

In addition to coins, a system gradually developed involving paper money. Banknotes were a receipt for a money issuer's claims on silver or gold. Instead of using coins as a means of payment, the receipt was used. This was more practical, but with the introduction of banknotes the authorities also introduced a new promise. They promised the bearer that they would redeem the nominal value of the notes in silver or gold. The value of the notes was entirely dependent on confidence in the issuer's promise. The authorities' ability to fulfil their promise depended on

[6] Glyn Davies (2002): *A History of Money from Ancient Times to the Present Day*, University of Wales Press, p. 200.

government finances. Brutal tax collectors, a well-filled treasury and peace with neighbouring countries inspired confidence in the authorities' ability to redeem the notes in a precious metal then or at some time in the future.

The authorities often granted a monopoly on banknote issuance to an institution they controlled. This was no coincidence in view of the seignorage revenues generated by printing money. This method of raising seignorage is temptation number two: the authorities borrow money from the issuing bank and the issuing bank provides the loan by printing banknotes. This was particularly common in times of war. It can be difficult to raise taxes or borrow directly from the public to fund an unpopular war. Naturally, a regime at war will be more interested in winning the war than in the long-term economic costs. Who cares about high inflation and debt repayment if surviving as a regime is at stake?

Confidence – and the lack of it – had important consequences for England and France during the Napoleonic Wars. England was able to finance these wars more easily than France. The English government could draw on several funding sources. They raised taxes, but could also borrow, partly from the public and partly from the central bank. They had previously demonstrated that they stood by their commitments, and were therefore granted loans. The French government, on the other hand, had lost its creditworthiness after Louis XVI was sent to the guillotine. The only source of funding that remained was taxation, eliminating the option of spreading war expenditure over time[7].

Our own history also illustrates the costs of inflation and a loss of confidence. Soaring inflation in Norway during and after the Napoleonic Wars impaired the functioning of the payment system. The function of money as a unit of measurement was also undermined. An example of this is described in the local history books for the coastal districts of Karlsøy and Helgøy in Troms, northern Norway. At that time, accounts were sometimes kept in silver, or in goods such as cod liver oil, large saithe or flour[8].

Inflation also resulted in the transfer of assets from creditors to debtors: the real value of the fishermen's debt to merchants in Bergen decreased. This marked a historic shift. The fishermen were of course happy to see their debt diminish. Creditors, however, lost money, which probably did not increase confidence and a willingness to lend the next time someone needed a loan.

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[7] Michael D. Bordo and Eugene N. White (1990): "British and French Finance during the Napoleonic Wars", NBER Working Paper No. 3517, also published in Michael D. Bordo and Forrest Capie (Eds.): *Monetary Regimes in Transition*, Cambridge University Press, 1993.

[8] Håvard Dahl Bratrein (1989-1994): *Karlsøy og Helgøy bygdebok*, Karlsøy kommune, http://karlsoy.com/bygdebok/

The promise of a stable value of money against gold and silver

I have given examples of how easily monarchs succumbed to the temptation of an apparently free lunch by exploiting opportunities for raising seignorage revenues. In times of political instability, they sometimes had no choice. But eventually, the authorities learned that the costs were high. The public pays an inflation tax, the monetary system is impaired and economic growth slows.

The economic progress experienced by Norway and other countries in the second half of the 1800s was founded on more than a thousand years of money and credit history. The authorities probably knew that a credible promise of a stable value of money measured in metal was one of the cornerstones of the success experienced by cities in northern Italy during the Renaissance and in 17th century Netherlands. They knew that confidence in the promise of a stable value of money could be maintained by relinquishing seignorage and limiting the issuance of money. The opposite was equally true. Kåre Lunden, for example, writes that "after 1387, no coins were minted in Norway for a hundred years". According to Lunden, the deep crisis in the Norwegian economy between 1350 and 1500 was not only due to the Black Death but also to the absence of a monetary system.[9]

Stability in the value of money eliminated uncertainty and doubt among potential investors. Long-term planning became easier. Providers of credit could be reasonably certain that their investment would not be inflated away. They did not have to move their wealth into property or other fixed investment in order to preserve it. The willingness to save and accumulate wealth increased.

History had taught the authorities the value of price stability, and the commitment mechanism was a monetary system linked to silver or gold. The whims of French kings were replaced by parliaments that were accountable to the people. It is no coincidence that the name of the most prominent great power's monetary unit – the pound – reflected a measure of weight: the value of a pound of silver.[10]

Credibility hinged on orderly government finances and a stable political situation, which contained seignorage temptations and in turn strengthened public confidence in the value of money. These conditions need to be in place to enable a central bank to keep its promise!

When Norges Bank was established in 1816, credibility was ensured by establishing a tax-financed silver fund. A par value against silver for the new paper money – the speciedaler – was announced. However, the market value of the speciedaler was considerably below par value – the

[9] Article by Kåre Lunden in the newspaper *Klassekampen*, 11 November 2008.
[10] *Encyclopædia Britannica*, http://search.eb.com/

authorities in our young country were in a difficult financial situation and had not yet established confidence. It was not until 1822 that the authorities were able to establish a more orderly system when the Storting adopted a long-term strategy whereby the silver value of the speciedaler would gradually increase to par value.[11] This goal was reached in 1842, twenty years later, bearing witness to long-termism and persistence in policy implementation.

And persistence was rewarded. The rest of the 1800s and the period to the First World War were generally characterised by price stability and strong growth in the Norwegian economy, even though there were also periods of weaker growth.[12] Towards the end of this period, confidence provided Norges Bank with the scope to adjust the interest rate to the domestic economic situation rather than solely in relation to the gold standard. [13,14]

The era of broken promises

The interwar years proved to be highly turbulent, both in Norway and abroad. In 1921, for example, per capita GDP in Norway fell by 11 per cent. The structure of the economy had changed, the functioning of the labour market had deteriorated[15], external trade had become more important and the share of employment in agriculture had declined. We had become more vulnerable to external economic developments.

The objective of monetary policy continued to be a stable value of money in relation to gold. However, the authorities set a very ambitious goal: they aimed to restore the krone's pre-war value, which implied deflation. Moreover, they were more impatient than had been the case after the Napoleonic Wars a hundred years earlier. At that time, the par value of money had been restored over a period of 20 years, but now the authorities achieved the same in a quarter of the time, at considerable real economic cost.[16] We usually refer to this as "parity policy".

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[11] Øyvind Eitrheim (2005) in Øyvind Eitrheim and Jan F. Qvigstad (Eds.): "Tilbakeblikk på norsk pengehistorie. Konferanse 7. juni 2005 på Bogstad gård (Norwegian monetary history in retrospect. Conference, 7 June 2005, Oslo)", *Occasional Papers* No. 37, Norges Bank.

[12] See for example Fritz Hodne and Ola Honningdal Grytten (2000): *Norsk økonomi i det 19. århundre* (The Norwegian economy in the 19th century), Bergen: Fagbokforlaget.

[13] In Norway, the silver standard was replaced by the gold standard on 1 January 1874. See annex by Ragna Alstadheim in "Valutakursregimer – historiske erfaringer og fremtidige utfordringer (Exchange rate regimes – historical experience and future challenges)", by Jan F. Qvigstad and Arent Skjæveland (1994) in *Stabilitet og langsiktighet: Festskrift til Hermod Skånland* (Stability and a longtermism: Festschrift for Hermod Skånland) (1994), Oslo: Aschehoug.

[14] Lars Fredrik Øksendal (2008), "Monetary policy under the gold standard – examining the case of Norway, 1893-1914", *Working Paper* 2008/14, Norges Bank.

[15] See Olav Bjerkholt and Jan F. Qvigstad (2007): "Introduction to Ragnar Frisch's 1933 pamphlet 'Saving and Circulation Regulation'", in *Revisita di Storia Economica*, Banca d'Italia.

[16] See Øyvind Eitrheim, Jan T. Klovland and Jan F. Qvigstad (Eds.) (2004), p. 293 in "Historical Monetary Statistics for Norway 1819-2003", *Occasional Papers* No. 35, Norges Bank.

The ambition to keep their promise was admirable, but the follow-through lacked flexibility.[17] We might say that in the 1920s, the central bank adhered rigidly to “the letter of the law”.[18]

After the Second World War, unemployment in the 1920s and 1930s was often associated with the rigidity of “parity policy” [19], which led to considerable changes in views on economic policy.

The objective of a fixed exchange rate and a gold standard nevertheless remained intact and was achieved. Norway and a number of other countries pegged their currencies to the dollar under the Bretton Woods Agreement. In reality, they also linked the value of their money to gold, since the dollar was linked to gold.[20]

The postwar period was marked by the strong conviction that the economy could be fine-tuned by the coordinated use of instruments decided at a centralised level. The value of the krone was pegged to the dollar and to gold while a policy of low interest rates was accompanied by an ample credit supply. This was possible in a highly regulated economy. The positive attitude to regulation probably stemmed from the period of rationing and centralised government during the Second World War. The system had functioned reasonably well and a regulatory apparatus was already in place.[21]

Internationally, there was a widespread desire to stabilise economic developments, originating in theories published by John Maynard Keynes in the early 1930s. This was part of the background for Norwegian politicians’ ambition to fine-tune the economy in Norway. The works of A. W. Phillips[22], published in 1958, also supported this view. According to Phillips, a country could choose between low unemployment and low inflation. This menu option is often referred to as the Phillips curve. And what kind of “option” was that? Unemployment is real, while inflation is only changes in an index! By formulating the question in this way, the choice was obvious. This analysis had a considerable impact on economic policy in many western countries.

The global economic situation became difficult into the 1970s, with low growth and high inflation

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[17] However, they were more flexible in September 1931. It only took seven days for Norway to follow the UK’s lead in abandoning the gold standard.

[18] There was a fairly general consensus on parity policy in the 1920s. See for example Fritz Hodne and Ola Honningdal Grytten (2002), pp. 111-112 in *Norsk økonomi i det 20. århundre* (The Norwegian economy in the 20th century), Bergen: Fagbokforlaget, and Hermod Skånland: “Det norske kredittmarked siden 1900 (The Norwegian credit market since 1900), *Samfunnsøkonomiske studier* No. 19, Statistics Norway. See also Knut Mykland (Ed.): *Cappelens Norgeshistorie*, Vol. 13, p. 86, Oslo: Cappelen 1976.

[19] For further discussion of parity policy and Norges Bank’s role, see Gunhild J. Ecklund (2008), pp. 46-51 and 67-71 in “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, Oslo.

[20] This link to gold was not as strong as when the obligation to redeem in gold applied. Under the Bretton Woods system, countries whose public finances were in disequilibrium, or who allowed inflation to rise for other reasons, had to let their exchange rate depreciate against the dollar. When the exchange rate against the dollar fell, the value of money measured in gold decreased.

[21] See Olav Bjerkholt (2008): “Sosialøkonomenes oppmarsj og nasjonalbudsjettet (The rise of the economist and the national budget)”, *Samfunnsøkonomen* Nos. 6 and 7, Vol. 68

[22] Alban W. Phillips (1958): “The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957”, *Economica*, Vol. 25, No. 100, pp. 283-299

in Norway and other countries. The US and European authorities opted to pursue an active countercyclical policy rather than combating inflation. But the trade-off between inflation and unemployment did not hold in the long term, as economists had first thought. Their analyses had not factored in expectations formation. When higher inflation gradually came to be expected by economic agents, it no longer led to lower unemployment.

In his work, Phillips introduced the dilemma of short-term gains and long-term costs in a new area. The benefit was lower unemployment for a period. But confidence that inflation could be kept low would eventually be eroded. The cost was persistently higher inflation. The short-term benefit evaporated along with confidence.

It is easy to see that it can be tempting to exploit the short-term gains even though the long-term costs are known. In 1971, for example, US president Richard Nixon sought higher growth in the money supply and an attendant reduction in unemployment in order to increase his chances of being re-elected.[23] He was aware of the inflation problems that would subsequently arise, but his view was that they could be addressed at a later stage. Perhaps he believed that if he were not re-elected, the long-term costs would be someone else's problem. The lesson we can learn from this is that a system involving changing governments may be particularly prone to short-term temptations. Finding an effective commitment mechanism is of particular importance in this context.

Because of a lack of fiscal discipline, the Federal Reserve suspended its obligation to redeem dollars for gold in 1971 and the Bretton Woods Agreement collapsed. This was the beginning of a period of inflation and economic instability in many parts of the world, referred to as the decade of the Great Inflation. In Norway as in other countries, the government moved in practice away from the objective of a permanently stable exchange rate.[24] It carried out ten de facto devaluations of the krone in the period 1976-1986[25], which led to high inflation. Data on price developments in Norway are available back to 1516. Five hundred years of price history show that in historical terms the inflation period in the 1970s and 1980s is unique.[26] Previously, periods of high inflation

[23] Milton Friedman and Rose D. Friedman (1998): *Two Lucky People: Memoirs*, University of Chicago Press, pp 386-387. More rapid growth in the money supply would imply lower interest rates in the short term.

[24] In 1975, Thomas J. Sargent and Neil Wallace published the article " 'Rational' Expectations, the Optimal Monetary Instrument and the Optimal Money Supply Rule" in *Journal of Political Economy*, Vol 83, No. 2, April, pp 241-254. According to the article, monetary policy had to come as a surprise in order to have any impact on the economy. Expected policy had no effect. This was probably also part of the reason for the acceptance of diverging from promises made, and may explain why transparency was of so little interest to the authorities. Theoretical works published some years later showed that expected and rules-based policy could nonetheless stabilise the economy provided price and wage rigidity existed. Some examples are: Stanley Fischer (1977): "Long-Term Contracts, Rational Expectations, and the Optimal Money Supply Rule", *Journal of Political Economy*, 88, No. 1, pp 191-206), John B. Taylor (1980): "Aggregate Dynamics and Staggered Contracts", *Journal of Political Economy*, 88, No 1, pages 1-24 and Guillermo A. Calvo (1983): "Staggered Prices in a Utility-Maximizing Framework", *Journal of Monetary Economics*, 12, No. 3, pp 983-998. Only when these articles were published was the theoretical basis in place for keeping promises while at the same time allowing monetary policy to contribute to stabilising the economy.

[25] See reference in footnote 13.

[26] See Jan F. Qvigstad (2005) in Øyvind Eitrheim and Jan F. Qvigstad (Eds.): "Tilbakeblikk på norsk pengehistorie. Konferanse 7. juni 2005 på Bogstad gård (Norwegian monetary history in retrospect. Conference, 7 June 2005, Oslo)", *Occasional Papers* No. 37, Norges Bank.

had been associated with government deficits as a result of war and unstable governments. This time, inflation was related to the system of economic policy management.

The era of high inflation must be viewed against the background of the mixed experience of the parity system and reduced weight on keeping promises, ambitious economic stabilisation policies and belief in the validity of the Phillips curve. In addition, the importance of a stable value of money had perhaps lost some of its prominence.

As there are many lawyers present here today, I will venture to comment on a case in your field of expertise: the so-called gold clause case ("Gullklausulsaken").[27] The Norwegian government had issued a number of bonds in the period 1896 to 1909.[28] Many of the bonds were held by French moneylenders. The bonds were issued in the gold standard period and the moneylenders were promised repayment in "monnaie d'or". When the bonds matured, the Norwegian government wanted to make the repayment in banknotes that had lost much of their value. This implied a devaluation that could perhaps be compared to the devaluation under Henry VIII. The French moneylenders refused the offer and the case finally came before the Supreme Court in 1962. In their voting, the Supreme Court gave weight to a law from 1923, which stated that the gold clause, i.e. repayment in gold money, did not apply if the obligation to redeem banknotes for gold had been suspended, which it had been permanently in 1931. In the explanation of its ruling, the Supreme Court also referred to "vital national interests". It would cost Norwegian taxpayers far too much to repay the gold money that had been borrowed 60 years earlier.

It would be far too pretentious of me to offer an opinion on the court ruling as such. What makes this case interesting in the light of today's topic is that in the Supreme Court's assessments of "vital national interests", there is no discussion of what the nation's interests are in the short term versus the long term. However, it must be added that it is probably not easy for a court to review other government authorities' assessments of this point. There is also the question of whether this falls within the court's purview.

Modern monetary policy – a promise both possible and right to keep

The theoretical breakthrough by Kydland and Prescott and the era of high inflation eventually had implications for practical policy. It was observed that countries where weight was given to low inflation, such as Germany, had recorded favourable economic developments.

Since the beginning of the 1980s, there has been a broad international consensus that monetary policy must be geared towards price stability. This paradigm shift also reached Norway, but not

[27] Henrik Bahr (1962): "Høyesteretts dom i gullklausulsaken (The Supreme Court ruling in the gold clause case)", *Lov og Rett*, No. 5, pp 193-211

[28] Two government-guaranteed banks had also issued bonds.

until the end of the 1980s. The government recognised that the frequently repeated devaluations had become ineffectual. Confidence had been lost. In Norway, inflation had also soared without a fall in unemployment. Even if it was costly to restore credibility, in reality we had no choice.[29] The alternative was to bring the country even closer to the brink of financial chaos and runaway inflation. The devaluation in 1986 would be the last in the series.

Internationally, the 1980s ushered in three innovations that would become decisive for the shaping of modern monetary policy as we know it today.

First, market deregulation led to freer cross-border capital flows. Promises could no longer be relegated to the future. Failing credibility was promptly reflected in higher interest rates and weaker exchange rates. Nixon's disinflation plan to bring down inflation at some point in the future would have had immediate consequences. On the other hand, it also became clear that a credible and transparent monetary policy could be more effective precisely thanks to financial markets' swift reactions.[30]

Second, the notion of central bank autonomy regained favour. Political authorities who wanted to show the world that they were committed to delivering their promise of price stability did as Ulysses and let themselves be bound to the mast. The mechanism was central bank independence and Norway was no exception. The new Norges Bank Act of 1985 gave Norges Bank the authority to set the interest rate. Democratic control is now ensured through a clear mandate defined by the government for the central bank's conduct of monetary policy. The political authorities can verify the central bank's compliance with the mandate without deciding on the use of the instrument.[31]

The third innovation sprang out of New Zealand. In connection with economic reforms, the authorities had introduced fiscal performance targets. They then started searching for good and realistic performance targets for monetary policy. They found that what monetary policy should deliver was stable inflation in the medium term – New Zealand introduced a so-called inflation target for monetary policy.[32]

What is the difference between what is referred to as inflation targeting and the former policy of parity? Let me explain the difference using a stylised example. Assume that the price index

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[29] The new recognition that policy should be based on confidence rather than a series of surprises reflects the influence of theoretical developments on practical policy, c.f. footnote 24.

[30] In recent times, central banks throughout the world have become more independent but at the same time more transparent and predictable in their communication with other economic agents. This is also related to the new recognition referred to in footnote 24.

[31] Norges Bank reports on the conduct of monetary policy in its *Monetary Policy Report* and *Annual Report*. Norges Bank's reporting obligations are set out in Article 75c of the Constitution and Section 3 of the Norges Bank Act. The *Annual Report* is submitted to the Ministry of Finance, presented to the King in Council and communicated to the Storting in the Government Credit Report. The Governor of Norges Bank also appears at open hearings of the Standing Committee on Finance and Economic Affairs.

[32] Canada, the UK and Sweden followed suit, and in the Euro area, the objective is to achieve consumer price stability in the area as a whole, rather than in each individual country. The arguments for a stable value of money are the same as for Norway.

has been 100 over a longer period. The price level is thus stable. An increase in, say, energy prices then occurs and the index moves up to 105. Energy has become more expensive relative to other goods. Under the parity system, other prices had to be reduced to move the index back to 100. This could require a substantial decline in output and employment, as was the case in the interwar years. Under an inflation targeting regime, it would in this example be accepted that the index remained at 105. The central bank would ensure that economic agents did not believe that inflation of five per cent – an index with an annual rise of five per cent – had become the normal level, thereby preventing such a belief from affecting their behaviour. Under an inflation targeting regime, the central bank would accept, when shocks occur, a price increase without other prices having to be reduced. The promise made under an inflation targeting regime is easier to keep when the economy is exposed to major shocks than the promise made under a parity system.[33]

From 1986 to the beginning of the 1990s, Norway maintained a fixed exchange rate against European currencies without devaluations. In practice, this meant that Norway also had to pursue the same inflation goal as those countries. In autumn 1992, the fixed exchange rate regime collapsed. Even if we no longer operated a formal fixed exchange rate system, in the following years monetary policy was still oriented towards maintaining a stable exchange rate at all times.[34] However, the currency turbulence in the latter part of summer 1998 demonstrated that like other central banks, Norges Bank could not make good on the promise to maintain a stable exchange rate from hour to hour, day to day or week to week. Domestic economic considerations indicated that there were limits to how high the interest rate could be set in support of the krone exchange rate. An excessively high interest rate would not have been credible since it would have resulted in an excessively sharp downswing in domestic economic activity.

In August 1998, Norges Bank shifted policy to setting the interest rate with a view to keeping inflation low and stable over time.[35] The shift in monetary policy was explained in articles and

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[33] Another difference is that under parity policy the authorities stabilised the price of gold and not the price of a basket of representative goods – the consumer price index. Today, stabilisation of the consumer price index would be described as price level targeting. Inflation targeting, on the other hand, implies stabilisation of the *changes* in the consumer price index. There is also a difference in that there is no longer any redemption obligation. Confidence is not based on gold reserves, but more generally on responsible economic policy as a basis for achieving the inflation target through the active use of the interest rate.

[34] At that time, little academic research was available on alternatives to a fixed exchange rate regime or money supply targeting. Leading politicians and economists were sceptical about the idea of abandoning the fixed exchange rate regime. Money supply targeting was regarded as out of the question because of instability in the money supply. John Taylor's works on interest rate rules that could contribute to stabilising inflation and the real economy, through transparency and predictability, were not published until 1993 (John B. Taylor: "Discretion versus Policy Rules in Practice", *Carnegie-Rochester Series on Public Policy* 39, pp 195-214).

[35] Kjell Storvik (1998): "Aktuelle økonomiske og pengepolitiske problemstillinger (Current economic and monetary policy issues)". Lecture at Forex Norway's 43rd general assembly, 28 August 1998. See www.norges-bank.no. Norges Bank was prepared for a change in regime, cf . the discussions in Anne Berit Christiansen and Jan F. Qvigstad (Eds.) (1997): *Choosing a Monetary Policy Target*, Oslo: Universitetsforlaget, and Jan F. Qvigstad and Øistein Røisland (Eds.) (2000): *Perspektiver på pengepolitikken* (Monetary policy perspectives). A workshop entitled "The Conduct of Monetary Policy in Open Economies" was also held at the Norwegian Academy of Science and Letters in October 2000.

statements in early winter 1999.[36] The inflation target was finally formalised in a new regulation on monetary policy in 2001, a good eleven years after New Zealand, ten years after Canada, nine years after the United Kingdom, and eight years after Sweden.

The mandate for Norges Bank states that monetary policy shall, in addition to securing price stability, contribute to stabilising output and employment. It is possible to give weight to cyclical fluctuations in interest rate setting, and to new information, as long as there is confidence that inflation remains near the target. The central bank's announced interest rate strategy ahead will be adjusted as new information emerges. This stands in contrast to the parity system, which was more rigid.

The authorities cannot systematically allow policy to be more expansionary than announced to bring down unemployment. As Kydland and Prescott demonstrated, this would in the long term lead to higher inflation without lower unemployment. Credibility hinges on the active use of the interest rate to attain the target.

Michael Woodford, who is a judicial expert and professor in economics at Columbia University, has pointed out that in order to keep your word it is not enough to make a promise today and keep this promise tomorrow.[37] When making interest rate forecasts, we must also take into consideration the promises made yesterday. Only then can we fully utilize expectations to optimally stabilise the economy. This is referred to as monetary policy from a timeless perspective.[38] My understanding is that a person will likewise both look backward and forward when interpreting the laws of a society. It is Norwegian court practice for judges to consider precedent effects and case law when interpreting legislation.

Today there is general consensus that price stability is not only the best contribution that monetary policy can make to economic stability over time, but perhaps also the only promise the central bank can actually deliver.

Today's financial crisis

At present, the world is in the throes of a severe financial crisis – the deepest crisis since the 1930s. Many foreign banks have suffered large losses and a sense of fear is prevailing. We are

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[36] Article in the daily newspaper *Aftenposten* on 5 January 1999 in connection with the appointment of Svein Gjedrem as governor of Norges Bank; lecture by Svein Gjedrem, Gausdal, 28 January 1999: "Utfordringer i den økonomiske politikken (Challenges to economic policy)" and article by Svein Gjedrem in *Aftenposten* 4 May 1999: "Utfordringer i pengepolitikken (Challenges to economic policy)".

[37] Michael Woodford (2003): *Interest and Prices*, Princeton University Press

[38] Michael Woodford (2003) points out that the central bank's announced interest rate strategy can be adjusted as new information becomes available. However, in order to maintain confidence in the announced interest rate path and for it to be useful, the public must not have reason to expect *systematic* deviations.

entering a global economic recession. The authorities are taking action to restore confidence in the financial industry. Macroeconomic policy measures are aimed at limiting the crisis-related effects on the real economy. It is clear that regulatory improvements will eventually be needed so that the financial industry can assume a greater role in safeguarding their own credibility.

The credibility of central banks is also being tested in this situation. In dramatic cases, such as Iceland, we are again seeing an example of runaway inflation when confidence in government finances is severely impaired. In this situation, inflation targeting at the central bank of Iceland did not suffice. In Iceland, the problems stemmed from an oversized financial industry and fundamental macroeconomic imbalances. When the banks encountered problems, the authorities provided support in an attempt to secure a functioning financial system. As the Icelandic state did not have the financial strength to take over the banks' total commitments, confidence in its currency and monetary policy was also shattered without the central bank being able to remedy the situation.

The financial crisis is a global one, and the Norwegian economy will be affected. However, our country is in a sound position to curb crisis-related effects. In Norway, government finances are healthy, the banking system is solid and there is confidence that monetary policy will continue to maintain a stable value of money. This means that we can use the interest rate actively. We have already reduced it in two increments, by a total of 1 percentage point, and we are willing to use the interest rate to a further extent if necessary.

Central banks still face many unknowns about economic behaviour. There is nothing in our history that indicates that monetary policy, or any economic policy for that matter, has found its final form. But there is one certainty: keeping promises and creating confidence are fundamental both for monetary policy and more generally for growth and development.

Legal commentary

by Endre Stavang[*]

"A promise is a promise and a man is a man" is an old saying that still holds true. Many lawyers earn their living drawing up major commercial contracts, and it is taken as a given that these contracts – by law – are binding in their original form. If this were not the case, the promisee would feel insecure as to whether the promisor would later be tempted to renege, and this insecurity would in some cases deter the promisee from entering into the contract at all. Lofty words such as predictability, legitimate expectation and justice can be used to denote the values lawyers assign to the principle of the binding effect of promises and contracts.

But – and there is a but – from the perspective of jurisprudence, the principle that contracts are binding is not much more than that – one principle among many others. Some of these other principles point in the opposite direction. Thus, in practice, there must be room for exceptions. The most prominent Nordic legal expert on the law of obligations in the 20th century, Jan Hellner, has for example said that although the principle that contracts are binding functions as a practical rule of law in many cases, it is not particularly applicable in legal discussion: "The principle (that agreements are binding) is not applicable as an argument in legal discussion. However, it functions as a practical rule of law in the great majority of cases. As such, it can be said to be almost a tautology – it only states the obvious. Water is wet, the earth is round, and contracts are binding."[1] Nor does the principle say anything about the relationship to other principles or the fact that all contracts must be interpreted. And based on the general provision in Section 36 of the Contract Act, this can be taken even further, as stated in the first paragraph: "A contract may wholly or in part be set aside or changed to the extent its application would seem unreasonable or in conflict with good business practices. The same applies to unilaterally binding arrangements."

This provision does not state that agreements are binding in their original form. On the contrary, it states that subsequent circumstances may have considerable influence on whether and to what extent a contract is binding. If complying with an agreement in its original form proves to be too costly, the agreement ceases to apply, wholly or in part. This pragmatic approach pervades contract law: to make the best of a situation as it is.

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[*] Endre Stavang is associate professor at the Department of Private Law and member of the Natural Resources Research Group at the Universtity of Oslo. Any comments are welcome and can be sent to endre.stavang@jus.uio.no

[1] Jan Hellner, "Pacta sunt servanda", article in Bratholm et al. (Ed.): *Samfunn – Rett – Rettferdighet*. *Festskrift til Torstein Eckhoffs 70-Årsdag* (Society – Law – Justice. Festschrift on the occasion of Torstein Eckhoff's 70th birthday), TANO 1986, pp. 335–349, on page 348.

This is an elementary principle in law. Social scientists, however, are now asserting that there is much to be gained – and this also applies to government authorities – from keeping one's promises – if necessary by providing assistance in the event of the threat of legal repercussions. The objective is confidence and credibility. For social scientists, this is perhaps not primarily valuable in itself, but is something that leads to higher investment, more consumption, less unemployment and – more generally – markets that meet human requirements to a greater extent and more efficiently.

I understand the topic of "keeping one's word" as a kind of reference to the idea developed by economists and other social scientists of dynamic inconsistency or time inconsistency. This is probably part of human intuition, but in academia it has been further developed by Thomas Schelling and is reflected in second generation game theory on so-called dynamic interaction. In 1977, Kydland and Prescott published an analysis of time inconsistency in policy choices that extended the theory and applied it to fiscal and monetary policy. At its core, their finding was that many policy choices may be difficult to make in a dynamically consistent way. Assume that a rational and forward-looking authority chooses a schedule for its policy with a view to achieving the best possible outcome for the public in the period to which the policy applies. If the authority is given the opportunity to reassess and change the plan at a later date in the period, it is likely to do so because this will be the optimal approach for the period as a whole. But if people form expectations concerning the authority's behaviour based on their experience at this later date, they may not have the incentive in the next period to do what was essentially the best thing from the start. Kydland and Prescott suggest that the authority can achieve more if their scope for weighing the advantages and disadvantages of the different alternatives for action in period 2 is limited and if this is announced in period 1.[2]

I do not intend to refer directly to monetary policy or the strategy or legal position of the central bank. Instead, I will examine whether this main idea – that there is much to be gained from keeping promises – is viable in law in a more general context. My question is what guidelines and legal framework the main idea should provide for government bodies and the branches of government. I will try out the idea on the sphere of natural resources law, i.e. the rules of law that apply to property, hydropower, oil, gas and environmental protection. This is a significant area in the sense that there is much to be gained from good law and much to be lost from its absence.

As my first illustration – mostly to check that I have understood the basic point – I will look at the regulations prohibiting the erection of new buildings and the application of the authority

[2] The Royal Swedish Academy of Sciences, Finn Kydland and Edward Prescott's Contribution to Dynamic Macroeconomics: The Time Consistency of Economic Policy and the Driving Forces behind Business Cycles. Advanced information on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 11 October 2004, http://nobelprize.org/nobel_prizes/economics/laureates/2004/adv.html, p. 1–31 on pp. 2 and 5.

to issue a demolition order, cf. the Neighbouring Properties Act (Naboloven), Section 11, first paragraph:

"…If a building or other structure is unlawfully erected in such a way that part of the building stands on a neighbour's property, the neighbour is entitled to have it removed or modified. If as a result, expenses or losses incurred are so great as to be clearly disproportionate to the gain, and the owner of the building is not to blame to any appreciable extent, the owner may be awarded exemption from liability if the neighbour receives compensation in an amount that must not be set lower than the damage or inconvenience."

As we can see, the provision states that a building erected unlawfully on a neighbour's property shall be removed. However, the provision also states that the structure may remain standing if removal results in a waste of resources as assessed at the time of removal. Both lawyers and social scientists would probably say that the latter could easily undermine respect for the basic principle that buildings shall only be built on one's own property. From this perspective, the third rule in the provision should be noted: if the builder was negligent at the time of building, the building must be removed even though the cost at the time of removal seems excessive.

There is much to suggest that the reasoning behind Section 11, first paragraph of the Neighbouring Properties Act may be important for other parts of natural resources law. This should, however, be assessed for each of the three branches of government: the legislative, the executive and the judicial branch. I will offer an example related to each branch.

My first example refers to the *legislative* branch of government. It is a long established idea that the Constitution should limit the competence of the majority (see Articles 97 and 105 of the Constitution of the Kingdom of Norway). This can be perceived as a guarantee for positions under property law that increase investors' confidence that they will receive the expected return on their investments. My example, however, refers to something slightly different: the constraints on an owner's actions that are considered necessary for nature conservation. According to Norwegian legal tradition, owners must accept such encroachments on property without compensation. This was a source of frustration to property owners for a long period. The notion eventually emerged that property owners could respond by making their land less preservation-worthy, for example by destroying a natural or cultural feature of unique value or cutting down a forest worthy of preservation – before a preservation order had been considered. For this and other reasons, the Willoch government of the 1980s proposed new statutory provisions to compensate property owners affected by nature conservation decisions to a greater extent than had been customary. The idea was that conservation work could then be carried out in a more conciliatory atmosphere. In a sense, the authorities chose to honour a kind of tacit agreement between the government and property owners that there should be some balance between the parties that cannot be disturbed without financial compensation. It is this "agreement" that is binding.

My second example refers to the *executive* branch of government. My starting-point here is that municipalities and other government bodies, including the Norwegian parliament, are entitled, within certain general limits under administrative law, to make new decisions in the future notwithstanding decisions made in the past. A parliament cannot, for example, commit a future parliament to a decision concerning licensing policy. Something similar will apply to the exercise of local government authority, for example in deciding on and implementing area development plans. For major development projects, it will be of great value to private parties if they can be sure that future municipal councils will not change the area development plan on which they have based their investments. It has long been unclear to what extent precommitment is within the authority of the municipalities. This may result in private investment that is lower than socially desirable. However, new provisions in the Planning and Building Act provide legal authority for development contracts that may ensure a greater degree of predictability. Nevertheless, there is no explicit provision regarding precommitment of municipal executive authority, and as a result we have to rely on judicial precedents. A key Supreme Court ruling reported in 2007 (the road project judgment) stated the following:

"As the Supreme Court has pointed out earlier, government must have the authority to precommit their authority to a certain extent in relation to a contract if this is considered necessary or desirable in order to promote the purpose of the authorising legislation. The precommitment must, however, be kept within reasonable limits and the extent to which precommitments can be binding will differ across the different areas of government administration. The decision must depend on an assessment of the interest in the administration of government authority and public funds in the best interests of the people and the need to achieve the desired goals or solutions by precommitting the exercise of authority. To ensure that the question of binding a current administration to future commitments has been adequately assessed, the precommitment must be required to have a clear basis in the relevant contract."

It might be said that the Court has drawn up guidelines in this case that enable municipalities to make promises, and that the Planning and Building Act assumes that promises made by municipalities will normally be binding. As we can see from the wording of the Supreme Court ruling, the authority to make binding precommitments is generally regulated by three factors: first, the extent to which precommitment is desirable or necessary to promote the purpose of the Act; second, an assessment of the advantage of the exercise of discretionary authority against the need for binding precommitment; and third, how clear the basis for precommitment is in the relevant agreement.

My third example refers to the *judicial* branch of government. Passing judgment is a form of political activity in the sense that in difficult cases the judge applies discretionary judgment. A judge's personality and ethical principles ex ante will therefore influence his or her decisions ex post. This may result in reduced predictability, and as a result private parties may adapt to this uncertainty in various, perhaps undesirable ways. How can these harmful effects be reduced?[3] One possibility is to give emphasis in the application of law to objectively verifiable factors such as for example preparatory work (travaux préparatoires, which clarifies the intention of the lawmakers) and previous decisions (precedents). Where the wording of a law leaves substantial scope for discretion, the travaux préparatoires and precedents can narrow this down, making judgments more predictable. But some freedom of choice will almost always remain in difficult cases. The question then arises as to which ideology should determine the effect of a judge's ethical principles. There are two schools of thought here. Some would say that judges should take account of the concrete reasonableness between the parties at the time the conflict is to be resolved. Others argue that greatest weight must be given to general, normally applicable considerations. The most decisive factor will then be the reasonableness between the type of parties contesting the case, and the relevant time will be prior to the conflict. The first of these models can be called the ex post-school, and the second the ex ante-school.

Which school is the most suitable from our perspective? The answer is clear enough that a judge's ethical principles should be reflected in general assessments of which considerations are relevant ex ante. This corresponds to the old rule in the Swiss code of civil law: if no answer is to be found in the act, the judge shall apply the optimal rule from a legislative perspective. Such an approach ensures that the judge is forward-looking and takes account of the long-term consequences of his or her decision. This can be interpreted as the will to "keep one's promises".

I have provided three examples of how the judicial system can "keep promises". However, it would be easy to find contradictory examples to show that other considerations can be more important than confidence and credibility. In addition to what I have already said about this, it may, for example, be more important that a popular majority wins through at any time than that there is an optimal climate for investment, as clearly reflected in the road project judgement of 2007. Here, the Norwegian Supreme Court stated:

"Any doubts related to the possibility of a municipal authority precommitting its authority to allocate funds derive first from the possibility that the facts may change or that new information may emerge that was not available to the municipality when the contract was concluded. When a municipality has entered into a contract for a transport sector project, demographic developments or requirements imposed on municipal services might lead to an increase in municipal

[3] For an example of the view held by economists that it is relevant to examine the problem of dynamic inconsistency in the light of courts' rulings, see Luca Anderlini, Leonardo Felli and Allessandro Riboni, "Statute Law or Case Law?", CESifo Working Paper No. 2358 July 2008, http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1187642, pp. 1–48.

expenditure on social welfare or welfare services for the elderly or on the school and daycare institutions sector that could not have been envisioned when the contract was concluded. Second, political priorities may also have changed, as a result of a change in public opinion or a change in policy following an election. Insofar as it is accepted that an administration can precommit its authority, it will be difficult to accomplish a change in policy. This will constitute a constraint on democracy. In view of these doubts, the courts have been reluctant to accept agreements whereby the public administration can precommit its authority (see *NOU* 2003:24 "More effective building legislation", and Eckhoff and Smith, *Administrative Law*, which includes references to case law)."

In my opinion, there is every reason to continue to mull over these questions. We are facing complex problems of governance where interpretation and discretion are probably essential to our efforts to achieve good results.

Some philosophical reflections

by Henrik Syse[*]

The meeting between ethical and philosophical thinking on the one hand and hard financial matter on the other provides the setting for this article. This is a meeting that I daresay is a fruitful one for both sides.

First, academic ethics need to be tested against a world where self-interest is basically the governing principle (though with a potentially ethical justification), but where the necessity of an ethical framework around self-interest has gained increasing acceptance – many would say today: for the system to survive. As Franklin D. Roosevelt said in his second inaugural address in 1937: "We have always known that heedless self-interest was bad morals; we know now that it is bad economics."[1] In a situation where financial markets and major economic agents are themselves searching for the appropriate ethical bounds, academic ethics would have been feeble if it had nothing to contribute, and it would have been regrettable if it had not accepted the challenge and the opportunity to develop at times like these! Stephen Toulmin once wrote an article entitled «How Medicine Saved the Life of Ethics».[2] In the years ahead, moral philosophers will find particularly valuable work in the world of economics and finance.

But second, the world of finance and economics needs the language and approach of ethics – because ethics seeks to embrace the concrete human being, its needs, interests, rights and happiness. Economics seems to have a conspicuous frequency of abstractions in its language and models, to a certain extent from necessity, but often to an extent that is harmful. We have witnessed this in the financial crisis that is now sweeping over the world: concrete people with concrete mortgages were somehow transformed into sophisticated financial instruments, and these in turn became part of a world where actions are often very complex (cf. swaps, shorting and long-short-strategies – to use a few words I have added to my vocabulary over the past few years). None of these actions are unlawful or immoral in themselves. But because of their complexity, the risk of forgetting the underlying, concrete world of human beings is great. Ethics clearly has a role to play here.

«Keeping promises» is obviously an ethical issue, dealing with a fundamental moral principle that touches our everyday lives. We could go so far as to say that without some degree of

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[*] Henrik Syse is senior researcher at the International Peace Research Institute, Oslo (PRIO).

[1] «We have always known that heedless self-interest was bad morals; we know now that it is bad economics.» See http://www.bartleby.com/124/pres50.html.

[2] Published in *Perspectives in Biology and Medicine*, Vol. 25, 1982, pp. 736–750.

truthfulness and reliability in society, we would not be able to act. We plan our lives based on predictability and credibility. Any activity that cannot rely on such predictability will incur extra costs, to the insecurity and annoyance of many. Anyone who has experienced overbooking for a plane, hotel or rental car knows this; the companies involved cannot actually rely on people to keep their word, and they organise their bookings accordingly. When the day comes when all their customers keep their word and actually turn up, they will have a problem.

The Norwegian state has considerable power over economic policy, but has delegated some of this power to other bodies, with explicit mandates. The most important of these is the central bank. This relationship between powers is reminiscent of a specific view of the power of God, which was developed in the 13th and early 14th century and which also exerted considerable influence later: God is omnipotent (*potentia absoluta*), but proclaims to all his creatures that this power is limited in everyday life, it is a *potentia ordinata*. Hence, what a later era would call the laws of nature actually do apply, and human free will is respected.[3] According to this line of thinking, a miracle can indeed be understood as an exercise of God's absolute power when, for a limited time and for a particular reason, it sets the ordained or "ordinary" power of God aside. In other words: normal arrangements are suspended. On the basis of this wording, we could say that the US authorities are currently performing a miracle since they have suspended normal arrangements; not as a permanent, new scheme of things, but as a pure exception implemented with immense power. Country after country is following suit. The age of miracles is not past.

Miracles or not, *generally* keeping one's promises and respecting agreements – not least as a state institution with considerable influence over people's lives and expectations – is considered an ethical obligation that can be supported by all the leading ethical theories to be found in philosophy. Indeed, it is this ethical normality that in itself gives meaning to the exceptions: if there is no normal condition, exception has no meaning.

But each of the ethical theories that support truthfulness and reliability also pose questions as to the exceptions that it may be necessary to make.

As a moral philosopher, let me present a brief description of how the three most influential and most frequently alluded-to ethical theories – duty ethics, consequentialist ethics and virtue ethics – provide perspectives on truth and lies. It must at the same time be remembered that none of these theories can be unequivocally defined or is uncontroversial: they overlap to a great extent, and some philosophers will say that they complement each other while others will consider them to be in contradiction. I prefer not to pit them against each other, but to regard them separately as

[3] I have written about this in Henrik Syse, *Natural Law, Religion, and Rights* (South Bend: St. Augustine's Press 2007), Chap. 2. Also recommended are Francis Oakley's articles and books on the subject, including «The Absolute and Ordained Power of God and King», *Journal of the History of Ideas*, Vol. 59, 1998, pp. 669–690.

legitimate, useful, morally well-founded and complementary ways of viewing right and wrong in human actions.[4]

The most obvious ethical approach to keeping promises is via duty ethics. It tells us that keeping promises is about rules we are dependent on, as the chess player is dependent on agreement on the rules of the game. In the worlds of both "language games" and "action games", we evidently need rules about truth and truth-telling in order to be able to respond and relate to each other's statements and actions.

But this is not only about duty, but also about rights (which is why we often refer to duty ethics or deontological ethics as the "ethics of duty *and rights*"): the recipient of messages, e.g. about the state of the economy, has the right to know that the information received is truthful. Immanuel Kant argues that if someone lies or does not keep their promises, they are using their fellow man as an instrument to achieve their own end. And he adds, in his famous description of the categorical imperative in *Groundwork for the Metaphysics of Morals*[5], that not keeping one's promises is simply not conceivable as a universal law as such a law would both in theory and in practice render human interaction impossible.

And if something cannot be made universally valid, then nor is it morally right, according to Kant, as this implies making an exception for oneself – and, as already indicated, using others simply as a means to an end.

Duty ethics, however, presents us with an important counter question: Are there occasions where we are faced with *several* sets of duties, all of which cannot be fulfilled at once? If so, can duty ethics tell us which duty has precedence? Must we not make an exception when another, even more important duty is at stake?

This question leads us to the ethical theory that is most often regarded as the alternative and main challenger to duty ethics: consequential ethics. Consequential ethics is chronologically forward-looking, asking what will happen, and to whom, when a specific line of action is chosen. The most famous form of consequentialism is utilitarianism, which aims for the maximisation of utility in society. The measure of what is ethically right is not whether it fulfils a duty or protects a right but to what extent – in Jeremy Bentham's famous words – it brings the greatest happiness to the greatest number of people.[6]

There are two forms of utilitarianism based on somewhat different views of truthfulness and

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4 See also Henrik Syse, *Veier til et godt liv* (Oslo: Aschehoug 2005). See Marcia Baron, Philip Pettit and Michael Slote, *Three Methods of Ethics* (Oxford: Blackwell 1997) for a useful review of these three ethical theories.

5 Immanuel Kant, translated by James W. Ellington [1785] (1993): *Grounding for the Metaphysics of Morals* 3rd ed., Hackett Publishing.

6 See http://philosophy.lander.edu/intro/articles/bentham-a.pdf for a summary of Bentham's most important works on utility.

keeping one's promises. Rule utilitarianism states that we should follow the rules or general patterns that will bring the best results (usually referred to as «the greatest good for the greatest number»). The rule utilitarian fears, in fact, that a person who has to conduct a complete utility and consequence assessment before every single action will be partly overburdened and partly become cynical since human good will be reduced to a quantifiable amount that each action can and must be measured against.

As can be deduced from the above, act utilitarianism states that a utility and consequence assessment should in fact be performed for each action. And this is where the question becomes more interesting for our purposes. Instead of regarding keeping one's word as a duty in itself – either in terms of duty ethics, because it is a human obligation, or in terms of rule utilitarianism, because it is usually worthwhile – each action would have to be assessed separately and a choice would have to be made *in each and every case* when the rule should be kept and when it should be broken in order to serve the best interests of society.

If anyone finds themselves thinking about the Bush administration's attitude to international law as it was practised at the Guantánamo base, for example, you are right: that was indeed a case of political act utilitarianism systematised.

The danger of this approach is that confidence in a person's pattern of action and general credibility deteriorates. If it is known, for example, that the state has the prerogative of intervening in the central bank's authority at any time this seems to be politically opportune, even with the best of intentions, confidence and predictability in the system would rapidly beak down. However, in the individual case, this may not seem to be a weighty reason. If I know that a lie in one isolated case can get me out of an embarrassing situation, or be of considerable benefit to someone else, and no-one would seem to be hurt by it, why should I tell the truth? If torture in a particular case can actually prevent a major act of war, why should we nonetheless renounce it?

This problem can provide a lead into a third ethical theory, virtue ethics, where attitudes and character are primary, rather than the legitimacy or illegitimacy of actions as such. A virtue ethics philosopher will fear that persons who become accustomed to lying, who begin to torture other people, or who constantly renege on their promises, are harming themselves and their own ability to act morally and inspire confidence. Morality, according to virtue ethics, is about who a person is, their strength of character and who they become through their actions. The object of ethics is not merely actions, but also the character of the person performing those actions. Thus, unwavering morals, credibility and predictability are essential virtues.

But again, objections can be raised: Isn't Gregers Werle in Ibsen's *Wild Duck* a perfectly truthful person? But we would hardly call him virtuous! In line with Plato's observations in a number of his dialogues, virtue is not about the one-sided cultivation of one virtue, one set of qualities. It is about the interaction of virtues. The truly good person is indeed truthful, but he or she is also brave, moderate, wise and just. And isn't it possible that those virtues taken together lead us in a different direction than a stubborn insistence on the whole truth and nothing but the truth?

To sum up, these three ethical theories do not provide an unambiguous answer to the question of whether it is right to keep one's promises. But the tendency is clear: if we ask what kind of duties ensure respect and consideration between people, which actions are of most benefit or utility, and which virtues a good person should possess – particularly to ensure predictability and confidence in our society – philosophers will answer that the person and the institution that keeps its promises is infinitely preferable; we do not want a society characterised by mistrust, constant uncertainty and the absence of truthfulness as a moral virtue. Keeping one's promises is the standard; the exceptions must remain just that – clear exceptions, based on weighty reasons specific to each case.

When we refer to keeping one's promises, we often use the Homeric metaphor: being bound to the mast. It may seem both necessary and admirable to allow oneself to be bound in this way, but it is hardly particularly comfortable in the long run – nor a favourable position to manoeuvre a ship from. Socrates referred instead to the soul that, if it possesses certain qualities and virtues, can manoeuvre correctly, even when under extreme strain, because it knows that the most valuable thing of all can only be safeguarded when the soul does not allow itself to be sullied. To achieve this requires strength of will, steadfastness, long-term thinking and moral courage.

Let us always remember that the basis of the rules we are obliged to follow, the real value of keeping one's promises, lies in human dignity. We are under the obligation to keep our promises not primarily to exhibit moral constancy but to respect human dignity. And, as I indicated in my introduction: a financial theory or economic practices that lose sight of the dignity of human beings, will not inspire confidence, whether promises have been kept or not.

Afterthought on the dilemmas of binding

by Francis Sejersted[*]

Keeping promises is a key problem in politics. Promises must be made. That is to say we must know what frameworks apply so that we can act rationally and plan ahead. As Henrik Syse asserted in his address – we plan our lives based on predictability and credibility or confidence. But perhaps we should not promise too much. One should be cautious about promising so much that the promises cannot be kept or that keeping them entails disproportionately high costs. On the other hand, it may be difficult to know in advance the costs associated with keeping a promise. And if the costs are higher than assumed, perhaps the promise can be broken? Moreover, what is a promise? Promises are subject to interpretation. Steinar Tjomsland maintained in the debate that the concept is not very precise, and that political promises are particularly imprecise. The question also arises of the extent to which promises are expected to be kept when other principles are brought to bear. This brings us back to the starting point – the need for predictability and confidence, the relationship between short-term considerations and long-term confidence-building. The need for a sensible balance between short-term and long-term considerations was highlighted by Jan F. Qvigstad in his introductory speech.

No area is better suited to illustrate all these general dilemmas than monetary policy, as demonstrated by Qvigstad in his account of Norway's monetary policy history from the establishment of Norges Bank in 1816 to the present day. For more than 100 years, from the monetary act of 1816 until 1931, Norway had a stable monetary value linked to precious metals. There were two periods, after 1816 and during World War I, when the redemption obligation was suspended with an attendant fall in the value of money. However, on both occasions Norges Bank managed to increase the value of money to par through a monetary policy with – in the short run – detrimental effects on the Norwegian economy. Keeping a promise for more than 100 years is no minor accomplishment, but was it worth it? Keeping this promise was made possible by "binding oneself to the mast". Norges Bank's task was, as highlighted by among others Eivind Smith in the discussion, to ensure that the promises made by the state were kept by Norges Bank. Norges Bank was in effect assigned the responsibility for long-term confidence-building simply because the political authorities were of the view that they would not be able to keep their own promises, that they would too easily be led astray by short-term considerations.

The central bank governor during the interwar years, Nicolai Rygg, was the warmest defender of

[*] Francis Sejersted is professor emeritus at the University of Oslo and senior researcher at the Institute for Social Research (ISF).

keeping promises, which was indeed also his task. In the Supervisory Council's meeting room in 1927, he reaffirmed the commitment to return to par value:

> "It would not suffice to note that adhering to that once adopted would entail disadvantages; but it would also have to be manifestly clear that one was really not able to [...]. This is a question of fundamental importance for the nation through time. The difficulties that arise in connection with the transition to normal, legal conditions are transient. No one can close his eyes to the fact that they are very serious. But the life of the people is eternal and this involves a decision of significance across generations."

The consideration of long-term confidence-building is here given absolute precedence over the immediate exigencies ensuing from a crisis.

To use Qvigstad's sober turn of phrase, the ambitions were admirable, but unfortunate. The Bank "adhered rigidly to the letter of the law" with "considerable real economic costs". Experiences led to the pendulum swinging in the opposite direction through "considerable changes in views on economic policy".

Keynes' famous phrase that "in the long run we are all dead" is as such a rejection of giving priority to long-term policy considerations. His message expresses the prevalence of pragmatism and short-term considerations, which means that we should address today's problems today and tomorrow's problems tomorrow. One must not promise too much, at least not in the long term.

Over time, the pendulum would swing even farther out. This occurred when the Bretton Woods system collapsed in 1971 followed by a unique period of inflation in the 1970s and 1980s. As Qvigstad succinctly put it, the background for this period of inflation was not only that the importance of a stable value of money had faded into the background, but also that this implied "reduced weight given to keeping promises". In 1986, it became clear that confidence had to be restored. In reality, we had "no choice", as Qvigstad writes (– a phrase that was criticised in the debate). Since that time, central bank policy has sought to find a balance between short-term and long-term considerations, or between the situation's immediate exigencies and long-term confidence-building, by not promising more than what should and can be delivered. Today's policy is based on inflation targeting, i.e. interest rate changes are aimed at maintaining a moderate and predictable inflation rate.

From the mid 1980s, Norges Bank has gained a more independent role than it had during the social democratic period. Paradoxically, this occurred after the Storting (Norwegian parliament) adopted a new central bank act in 1985, which provided less leeway for Norges Bank than the previous and outdated act from 1892. Thus, Alex Cukierman has in his book *Central Bank Strategy since 1992* formally ranked Norges Bank as the least independent central bank among the western industrialised countries. In reality, however, the authorities have followed the international trend towards a new positive view of independent central banks. As *The Economist* wrote in 1993, "the principal battle for central bank independence has largely been won". Independence reinforces predictability, in line with the original notion of independence where a commitment is made to honour the state's promises independently of what the state would have done.

As I read him, Qvigstad cautiously draws a normative conclusion from his historical account: in weighing short-term considerations against long-term considerations, we saw an unfortunate tendency towards giving priority to short-term considerations. He wanted to remind us that keeping promises and instilling confidence is a long-term project and utterly fundamental both for monetary policy and more generally for growth and development. He also pays a little visit to the legal field. With reference to the ruling in the gold clause case, which he by no means seeks to refute, and where the consideration of "society's vital interests" forms part of the grounds for the ruling, he notes that there is no discussion of short-term interests versus long-term interests, of which interests are ultimately the most vital. It is precisely this assessment which is essential for him – and for Norges Bank.

Endre Stavang's speech provides a glimpse of the legal view of these dilemmas. In relation to his interpretation of the view of economists – that there are considerable gains associated with keeping promises – he raises the question as to whether this line of reasoning is fruitful in law. He does not really provide an answer to this question, but it is precisely the absence of an answer that may be of particular interest. It is sufficiently clear that predictability is fundamental to a legal system, i.e. laws must to some extent have the character of promises, or that contracts are made to be honoured. However, it is just as clear that these considerations might have to give way to other and more pressing considerations. The pragmatic view seems to be more prominent here than in the economist Qvigstad's view.

Stavang does not take a historical approach, but a certain development can perhaps be interpreted from the examples in his text. In the context of legislation, he points out that with regard to property seizure for nature conservation purposes, there has been a shift away from a practice without compensation to providing compensatory damages to the property owner. In principle, this involves a "contract" that must be honoured, as he says. Likewise, with regard to administrative authority, there has been a shift from a situation where local government could change area development plans without taking into account already planned development projects to legal provisions for regulating development contracts where predictability is secured to a larger extent. Finally, with regard to jurisdiction, he can perhaps be interpreted in the direction that the ex-ante school has become more dominant, i.e. when judicial discretion comes into play, and it does so in many cases, the judge should be guided by the general considerations that applied prior to a conflict rather than the present situation. This provides greater consistency over time and can be interpreted as the will to keep promises.

Stavang opens by quoting the general provision in Section 36 of the Act relating to contracts of 1983. The Act provides that a contract can be rescinded if it would seem unreasonable to apply it. To the layman, this seems at first sight very radical, and there was some discussion about this when the Act was adopted. As pointed out by Ola Mestad in the debate, the Supreme Court ruled in 1990 that contracts must be respected if the parties had agreed on the implications of the contract – even if they may seem unreasonable at a later time. This can also be interpreted as a tightening in the direction of the importance of keeping promises.

Predictability is a fundamental value in the legal system. These examples indicate that in the recent past there has been an evolution towards strengthening predictability, in parallel with the evolution of monetary policy since the 1980s. As Mestad has argued, keeping promises can seem to follow changing fashions, or be culturally determined. Perhaps this movement towards a greater degree of predictability could be interpreted as a reaction against social democracy's decisionism, which to a large extent made a virtue of being politically unbound, i.e. a certain disdain for a limited use of force and for giving weight to long-term confidence building in the form of giving and keeping promises.

If it is correct that such a movement exists, it is consistent with the breach in general international policy developments, as described by Tony Judt in the book *Postwar: A History of Europe since 1945*. Judt notes that in the 1980s the European left was in desperate need of a new rhetoric, and what they found, to their own collective surprise, was the constitutional rights rhetoric in European constitutions (p 564).

Stavang concludes his speech with a reference to the road project ruling of 2007. This Supreme Court ruling applies the traditional constitutional principle that municipalities could not make a precommitment to allocate funds. The Supreme Court argued that such a precommitment could prevent a shift in policy direction and hence represent a constraint on democracy. The general point relates to the question of how far the obligation of keeping "promises" made by *others* should extend. In the debate, Fredrik Sejersted stipulated that such an obligation is not that apparent. A parliament should not be able to bind the next parliament. It is legitimate to change the law. Laws are not contracts. He referred to the current private pressure on the public authorities to enter into legally binding contracts as an alternative to laws or resolutions.

The notion that binding undermines democracy is a somewhat curious argument that implies that there is a conflict between democracy and the constitutional state. The argument implies that it would be particularly democratic to be able to change democratically decided resolutions. If this view is taken to the extreme, democracy's possibility for adopting resolutions of any impact over time would be undermined. Is there perhaps a tendency to neglect long-term considerations here? The dilemma naturally exists, and is illustrated by the serious proposals put forward during the great era of constitutionalism 200 years ago, which suggested that we should write a new constitution every 30 years on the grounds that one generation should not be able to bind the next one.

The moral in this context is that one should *not* let oneself be bound too tightly to the mast. We have seen that Norges Bank was to keep a promise made by another – notably the state. But the point here was the binding. Norges Bank was by no means free in relation to the state's promise. On the contrary, the Bank was to ensure that the promise was kept. In the debate, Ola Storeng maintained that this was precisely the problem with central banks – that they kept promises to an excessive degree. This was for example said to have been the case when the Bank went too far in defending the krone exchange rate at the beginning of the 1990s, or when it later maintained a low interest rate for too long a period in order to push up inflation.

A recurrent theme in the discussion was that caution must be exercised in binding oneself or in making excessive promises. Steinar Tjomsland quoted Carl Jacob Arnholm: "You should not promise more than you can deliver when storms gather on the horizon". *Promises* of different kinds must naturally be provided simply because our lives are based on *predictability*, as Syse underscored in his introductory speech. Predictability is also a fundamental concern underlying our entire constitutional state. In the debate, Heidi Høivik warned us against excessive caution and promising too little. It would be too defensive not to make promises, she said. It is important that we have ambitions that can entail some form of promises for the future and that they are associated with a will to go to considerable lengths to fulfil the promises.

The parity policy of the interwar years is the great example of how detrimental it can be to make the great promises, and thereafter insist upon the great sacrifices that are needed to keep the promise ("the life of the people is eternal"), and finally have to lay down one's arms. The pendulum was going to swing to the opposite side, again with unfortunate consequences. Today, there seems to be some retreat from extreme pragmatism, and this applies to both fields we have visited – monetary policy and law – that is a step, albeit a very modest one, back to Rygg's position under parity policy.

The normative conclusion we can draw from the many speeches and interventions seems not only to be that we must strive to strike a balance between short-term and long-term considerations, but that it is still important to emphasise that creating confidence in the longer term is fundamental to politics and is not always safeguarded to the extent it should be. Pragmatism must not be driven too far. It may still be relevant to establish certain binding mechanisms. Moreover, promises *must* be kept because our lives are based on *credibility*, to quote Syse once again. On the other hand, exceptions from keeping promises must be accepted, but they must, as Syse noted, remain exceptions.

About the authors

Jan F. Qvigstad is deputy governor of Norges Bank. Qvigstad's published works include: *Stabilitet og langsiktighet: Festskrift til Hermod Skånland* [Stability and longtermism: Festschrift for Hermod Skånland] (1994, co-edited with Sigbjørn Atle Berg and Kjell Storvik); *Choosing a Monetary Policy Target* (1997, co-edited with Anne Berit Christiansen); *Perspektiver på pengepolitikken* [Perspectives on monetary policy] (2000, co-edited with Øistein Røisland).

Francis Sejersted is professor emeritus at the University of Oslo and senior researcher at the Institute for Social Research (ISF). Sejersted's published works include: *Demokrati og rettsstat* [Democracy and the Rule of Law] (1984), *Demokratisk kapitalisme* [Democratic capitalism] (1993), *Sosialdemokratiets tidsalder: Norge og Sverige i det 20. århundre* [The era of social democracy: Norway and Sweden in the 20th century] (2005).

Rune Slagstad is professor at Oslo University College and senior researcher at the Institute for Social Research (ISF). He is also editor of *Nytt Norsk Tidsskrift*. Slagstad's published works include: *Positivisme og vitenskapsteori* [Positivism and Philosophy of Science] (1980), *Constitutionalism and Democracy* (1988, co-edited with Jon Elster), *De nasjonale strateger* [The National Strategists] (1998), *Rettens ironi* [The Irony of Law] (2001), *Kunnskapens hus* [The House of Knowledge] (2006), *(Sporten) – En idéhistorisk studie* [On sports – A study concerning the history of ideas] (2008).

Endre Stavang is associate professor at the Department of Private Law and member of the Natural Resources Research Group at the University of Oslo. Stavang's published works include: *Naborettens forurensningsansvar* [Pollution liability under neighbouring properties law] (1999), *Erstatningsrettslig analyse* [Tort Law Analysis] (2007), *Rettsøkonomi* [Law and economics] (2008, with Erling Eide).

Henrik Syse is senior researcher at the International Peace Research Institute, Oslo (PRIO). Syse's published works include: *Rettferdig krig? – Om militærmakt, etikk og idealer* [Just War? Military Force, Ethics and Ideals] (2003), *Veier til et godt liv – filosofiske tanker om hverdagslivets etikk* [Paths to a Good Life – Philosophical Reflections on Everyday Ethics] (2005), *Natural Law, Religion, and Rights* (2007, co-edited with Gregory Reichberg).

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