Economic Perspectives

Annual address by Governor Kjell Storvik at the meeting of the Supervisory Council of Norges Bank on Thursday, 6 February 1997

Background

I would assume that many of you expect me to address the challenges currently facing monetary policy.

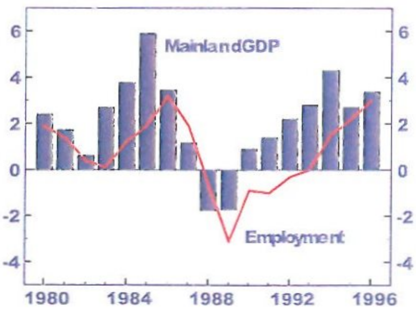
I would like to begin my comments on this topic by sharing an anecdote with you that might shed some light on the situation from the perspective of the central bank. Apparently, during the most intense stage of the negotiations on the dissolution of the union between Norway and Sweden, the author and patriot Bjørnstjerne Bjørnson sent a telegram to Prime Minister Christian Michelsen which read: «Now we must stand united!» Michelsen - who, of course, was directly involved in the negotiations with the Swedes and was more than familiar with Bjørnson's somewhat high-spirited temperament - sent a telegraph back saying: «Now we must keep our mouths shut!»

The story does not go on to reveal how our prominent author responded, but the *central bank* has recently adhered to the late prime minister's appeal.

The circumstances in the foreign exchange market should perhaps have induced me - even today - to follow his advice and confine my address to a different topic. However, that would have been conspicuous in itself. I hope that my remarks this evening can contribute to enhancing the understanding of the monetary policy situation from the vantage point of the central bank. Furthermore, I will attempt to elucidate the interdependence of monetary policy and other areas of economic policy.

The recent developments in the money and foreign exchange markets have taken place against the background of a highly favourable situation in the Norwegian economy - which is in fact so favourable that Norway is approaching a situation where the economy is operating near capacity with a

Chart 1
Mainland GDP and employment
Annual growth in per cent



Source: Statistics Norway and Norges Bank risk of rising price and wage inflation. The mainland economy expanded by more than 10 per cent between 1993 and 1996, and today employment is roughly 7 per cent higher than three years ago. Employment growth during this three-year period has been as strong as during the boom in the mid-1980s, accompanied by large current-account and fiscal budget surpluses.

In recent years economic policy in Norway has been based on three main pillars: Fiscal policy is oriented towards long-term balance in government finances, and it also bears the main responsibility for stabilising the economy. Monetary policy is geared towards stabilising the krone exchange rate, and thereby contributes to providing an anchor for income settlements and domestic price inflation. Incomes policy co-operation, which was formulated in the so-called «Solidarity Alternative», is responsible for maintaining the business sector's cost competitiveness through moderate wage growth.

Developments so far in the 1990s would indicate that this division of roles has been successful. However, in the course of 1996 we saw the first indications of new imbalances in the economy. There were signs of labour shortages in parts of the labour market, even though unemployment was still high by Norwegian standards. In some regions and sectors of the economy production was approaching full capacity utilisation. Moreover, some asset prices such as house and share prices rose sharply.

During 1996 the three main elements of economic policy were all exposed to greater strains. Wage growth was higher than previously and sharp growth in real wages contributed to a further increase in private consumption. It also proved to be more difficult than earlier to win acceptance for a sufficient fiscal tightening in view of the cyclical situation. Although the final budget was more or less in line with the original budget proposal, I presume it is no secret that Norges Bank would have preferred to see an even tighter fiscal stance, with more solid «margins of safety» in relation to the growth in domestic demand.

As autumn became winter, the krone came under persistent and growing pressure, with clear underlying expectations of a strengthening of the krone. Although Norges Bank lowered interest rates on several occasions in order to stabilise developments in the market, in addition to intervening heavily in the foreign exchange market, the krone appreciated and we ultimately deemed it necessary to refrain from undertaking heavy interventions for a period - in accordance with the guidelines set out in the exchange rate regulation.

Perhaps one should not be too surprised by these developments. Norway has accumulated large current account surpluses. Although a share of this surplus is matched by capital outflows via the Government Petroleum Fund, some of this surplus is absorbed by the economy and converted into kroner. Both export industries and oil companies make payments in kroner which have to be covered by earnings in foreign currency. With substantial surpluses on the current account, excess demand for the krone may thus rise occasionally. In such a situation both Norwegian enterprises and other foreign exchange market participants are easily prompted to accelerate their conversion of kroner in order to hedge against currency risk.

The large current-account and government budget surpluses, combined with favourable developments in output and employment, are factors which traditionally point to rising prosperity. Market participants naturally tend to assume that such a rise in prosperity will translate into a stronger currency.

However, this in no way implies that the recent developments in money and foreign exchange markets are of little concern to us. The appreciation of the krone will in principle have an impact on the business sector's competitiveness. Another and more indirect impact is a rise in domestic demand because Norges Bank is obliged to maintain a very low interest rate to stabilise the krone exchange rate. There is a risk that low interest rates may at worst result in unsustainable growth in the demand for goods and services, and a high krone exchange rate may engender an erosion of profitability in sectors exposed to international competition.

In other words, we are facing two main challenges: First, we must avoid a substantial and long-term erosion of industry's competitiveness. Second, we must avoid an overheating of the economy with a subsequent pronounced cyclical downturn. There is little Norges Bank can do to address the latter problem as long as monetary policy is geared towards maintaining a stable exchange rate. This implies that other components of economic policy - primarily fiscal policy - must be oriented towards curbing domestic demand growth.

The link between monetary policy and fiscal policy has figured prominently in many of my earlier speeches, and will be the main subject of my address this year.

Before reverting to this, I would first like to expand on my comments on the recent developments in the foreign exchange market.

The orientation of monetary policy

During the last three months of 1996 and up to 9 January of this year Norges Bank sold a total of NOK 75 billion through exchange-market interventions. During this same period key rates were lowered on two occasions by altogether 1 percentage point in order to reduce the return on krone positions.

This extensive use of instruments was not sufficient, however, to prevent a gradual appreciation of the krone. When pressures in the foreign exchange market heightened in the first days of January, Norges Bank deemed it was no longer appropriate to sell large krone amounts in order to stabilise the exchange rate. On 10 January, interventions were discontinued until further notice. The deposit rate, which forms the effective interest rate «floor» in the Norwegian money mar-

Chart 2
ECU index
January 1987 - January 1997

Source: Norges Bank

Chart 3
Nordic currencies against the ECU index
22 October 1990 = 100
October 1990 - January 1997

Source: Norges Bank

ket, was also reduced by a further $^1/_4$ percentage point to $3^1/_4$ per cent. Norwegian money market rates are now a good half a percentage point below the ECU rate and among the lowest in Europe.

The krone has since 10 January appreciated by about 3 per cent, and at the beginning of February 1997 was a good 7 per cent stronger than one year earlier. The krone exchange rate against the ECU is now at about the level prevailing at the beginning of the 1990s.

The exchange rate regulation which was issued in May 1994 defines Norges Bank's mandate for the conduct of monetary policy. The regulation states that «in the event of significant changes in the exchange rate, monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range».

I would like to make two comments on this particular point:

First, let me note that the possibility of significant changes in the exchange rate was explicitly recognised when the exchange rate regulation was formulated. It should not come as a surprise that in a situation with free capital movements, where the entire world in principle has access to the Norwegian krone market, the exchange rate will occasionally show some movements. There is a significant distinction between the prevailing target of a *stable* exchange rate and a pure *fixed* exchange rate regime - where the central bank has a legal obligation to maintain the exchange rate within predetermined and narrow fluctuation margins.

Second, I would like to make it perfectly clear that Norges Bank will, of course, orient instruments with a view to achieving the objective of a stable krone against European currencies. As mentioned, this is the background for the substantial reduction in interest rates down to well below the ECU rate at the beginning of January.

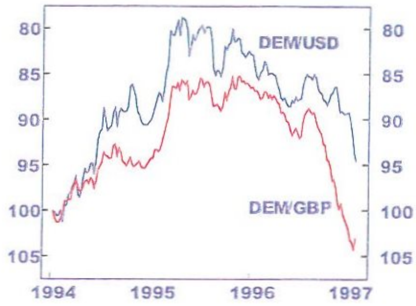
However, I would also emphasise that no one, including Norges Bank, can precisely predict movements in the exchange rate. The objective and direction stand firm, but we must still be prepared for shifting forces to influence us along the way.

Nonetheless, in the current situation I sense a perception in some quarters that the krone has appreciated on a permanent basis and will not return to its earlier range for a long time. I think this view fails to take into account a number of important factors which I would like to highlight.

The pressure against the krone in recent months may partly reflect transitory forces. High oil prices have a significant impact on the current account and also on the fiscal budget. The favourable cyclical situation in Norway may also, perhaps in the eyes of external observers in particular, create an impression of a solid economy and healthy government finances which at least in part reflect an abnormally strong expansion and high tax receipts.

In addition, the attractiveness the krone partly reflects external conditions, particularly linked to sluggish economic

Chart 4
Deutsche Mark against US dollar and pound sterling
Index 1 January 1994 = 100
January 1994 - January 1997



Source: Norges Bank

growth in continental Europe. Not least in Germany it has been difficult to achieve satisfactory growth. This has resulted in low German interest rates and a depreciation of the Deutsche Mark against the US dollar. The situation in the German economy and the substantial fluctuations between the dollar and the Deutsche Mark have also entailed that the Deutsche Mark has depreciated against other *European* currencies, for example pound sterling, and even against some ERM currencies. The Norwegian krone is thus not the only currency that has appreciated against the Deutsche Mark recently.

We could perhaps say that the krone has to some extent fallen prey to fluctuations in international currency markets. Developments in Germany and the US spur fluctuations in the exchange rate between the US dollar and the Deutsche Mark. In turn, pressures have arisen between the Deutsche Mark and other European currencies.

However, even in other continental European countries, growth has - at best - been patchy. The uncertainty associated with the establishment of EMU may also have compelled some investors to shy away from financial markets in continental Europe, and to search for investment alternatives. As a result, continental currencies have tended to depreciate both against the dollar and other European currencies, including the Norwegian krone.

This may imply that the large capital flows into Norway - and the associated upward pressure on the krone - can partly be ascribed to the sluggishness of the major economies in continental Europe and the uncertainty surrounding future exchange rate movements. If this is the case, it is also possible that some of this capital will flow back into the major European currencies when the economic situation on the continent is normalised and the uncertainty surrounding EMU subsides, with the effects this may have on the krone exchange rate.

On the other hand, this also implies that the krone exchange rate is determined by international conditions over which we have little control. This is a fate shared with other small countries in the world, and it would be misleading to suggest otherwise. We must admit that some of the decisive factors for the Norwegian economy, for example oil prices, are determined without Norway having much influence. Other nations' economic situation influences our *relative* position internationally, and when Norwegian businesses thrive while others falter, it is hardly surprising that some market participants would conclude that our currency is undervalued.

It is not uncommon for industrial countries with a relatively large share of commodity-based exports to experience some pressure against their currency when commodity prices rise and terms of trade improve. For some countries, this can even be perceived as beneficial because it may counter an overheating of the economy when earnings and incomes in employment-intensive commodity production rise sharply.

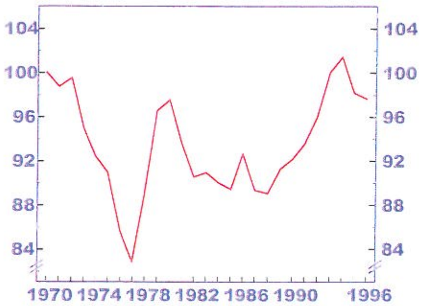
Norway's situation is different. The rise in export revenues derived from petroleum has only a negligible impact on business profitability. The revenues mainly accrue to the state and thereby do not have an immediate effect on demand in the economy. In Norway, therefore, a relatively stable exchange rate is preferable in the long run to ensure stable and predictable operating conditions for exposed industries.

Which factors influence competitiveness?

Some statements which have recently been made seem to imply that it is, above all, movements in the exchange rate which determine industry's cost competitiveness. However, competitiveness is influenced by a number of factors other than the exchange rate. *In the long run* economic stability in general - and the preservation of competitive industries in particular - must be seen in connection with the use of petroleum revenues in the economy.

This may be illustrated by taking a look at our recent economic history. Since 1970 Norway has experienced two distinct periods of deteriorating competitiveness. The first episode came in the 1970s when cost competitiveness declined by almost 20 per cent. This deterioration was due to a combination of an expansionary fiscal policy and persistent labour market pressures. In addition, the krone was linked to the Deutsche Mark for a period, which resulted in an effective appreciation of the krone. These developments reflected the fact that Norway had become an oil producer, which also made it possible to finance budget deficits by borrowing abroad on favourable terms.

Chart 5
Competitiveness measured by RULC in a common currency
Index 1970 = 100



The chart shows competitiveness measured by the trade-weighted index deflated by RULC. A falling index represents a deterioration in competitiveness. Measured in this way, competitiveness is now at around the level prevailing at the start of the 1970s.

Source: OECD, IMF, Statistics Norway, the Ministry of Finance and Norges Bank

The second period of eroding competitiveness spanned most of 1980s. Again the Norwegian economy was characterised by rising oil wealth, strong growth in demand and a gradual emergence of labour shortages. In the period from 1980 to 1988 the effective exchange rate depreciated by a total of 12 per cent. In isolation, this should have contributed to bolstering our competitiveness. However, - this time due to persistently high wage growth - the depreciation of the krone did not prevent competitiveness from deteriorating by nearly 10 per cent from 1980 to 1988.

Norway's competitive position thus shifted in the *opposite* direction of that implied by the nominal exchange rate in the 1980s. Furthermore, price inflation in Norway rose to considerably higher levels than among trading partners.

Contrariwise, in the two periods with substantial *competitive gains* towards the end of the 1970s and between 1988 and 1994, wage growth in Norway was markedly lower than among trading partners. Nor was there a clear-cut relationship between changes in the exchange rate and competitiveness in these two periods. The improvement in competitiveness towards the end of the 1970s, in addition to a price and wage freeze, may to some extent reflect a slight depreciation of the krone. However, the substantial competitive gains in the 1990s occurred, as we know, against the background of a generally stable exchange rate.

These developments can in part be explained by the functioning of the labour market and wage formation. A shortage of labour and sharp growth in demand - in addition to high price inflation - are factors that tend to erode competitiveness. Similarly, our experience shows that competitiveness tends to improve when the labour market slackens, demand growth abates and price inflation subsides.

In Norway, these factors have traditionally been heavily influenced by the orientation of fiscal policy. An increased use of oil revenues will boost the demand for goods and services from sheltered industries, thereby reducing the resources in the economy available to exposed industries. If pressures then arise in the economy, price and wage inflation will increase and competitiveness deteriorate. The experience of the 1980s, in particular, indicates that such a deterioration may take place irrespective of short-term movements in the exchange rate.

I am not implying that movements in the exchange rate are without significance to competitiveness. But we must take account of past experience when evaluating the overall effects of economic policy. This experience indicates that returning the krone exchange rate to an established range is of little help if unaccompanied by a sufficiently tight fiscal policy.

The business cycle and monetary policy

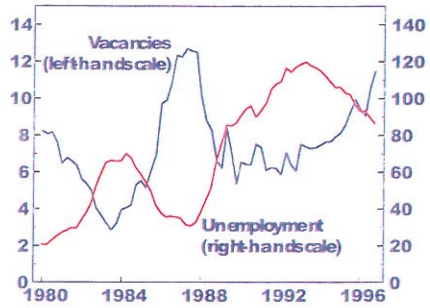
In the current situation the orientation of monetary policy towards exchange rate stability will tend to stimulate interest-rate sensitive domestic demand. Accordingly, fiscal policy must be oriented towards attenuating pronounced cyclical movements in order to avoid excessive demand growth.

It may be appropriate to recall how previous business cycles have resulted in long-term effects on employment, both in Norway and in other countries. International experience shows that unemployment rises more easily than it declines. It would appear that periods of high unemployment contribute to impairing skills in some parts of the labour force and increasing the risk of mismatches in the labour market. In addition, rigidities in the labour market may entail that wages are adapted to an employment level corresponding to those who already have a job, rather than to a level that would secure low unemployment. Such mechanisms have probably contributed to the rising trend in unemployment in Europe.

Recently, we have seen evidence of mismatches even in the Norwegian labour market. There has been a shortage of labour in the health and care sector for some time. A new feature is that in spite of continued high unemployment by Norwegian standards, there seems to be a shortage of labour in the construction industry and some manufacturing sectors.

Another indication of rising mismatches over the last ten years can be found when comparing the ratio of vacancies to the number of registered unemployed today with the ratio during the last cyclical boom of the mid-1980s. Although caution should be exercised when interpreting these figures, while the number of registered unemployed is almost three times as high as in the mid-1980s, the number of vacancies is now approaching the 1987 peak. This *may* imply that unemployment is partly due to a rising mismatch between vacancies and the skills available, or wide variations among regional labour markets.

Chart 6
Unemployment and vacancies
Seasonally-adjusted. In thousands



Source: Directorate of Labour

Another factor is that labour force participation in Norway, which is close to 73 per cent of the population between 16 and 74, is now record high. As a result, we cannot assume that employment growth will be offset by a continued strong expansion of the labour force.

To sum up, it would seem that continued buoyant growth in demand in the near future would more rapidly result in rising price and wage inflation compared with what we have experienced so far in the 1990s.

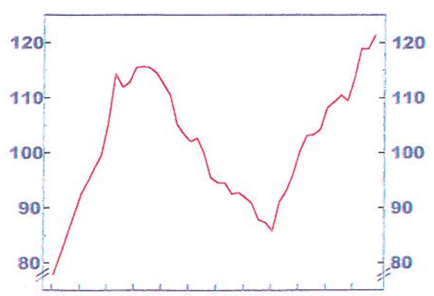
Norges Bank's projections, which are based on developments prior to the recent interest rate cuts, indicate a moderate, albeit steady, rise in price and wage inflation over the next few years, with an estimated inflation rate at the turn of the century of around 3 per cent. The moderate rate of inflation projected, despite nearly ten years of growth, largely reflects the subdued price inflation forecasted for our trading partners.

It is difficult to gauge the impact of the recent reductions in interest rates on the real economy. The effects will depend on the effect on various asset prices and how the increase in wealth feeds through to consumption and investment.

In Norway, interest rates largely affect the economy through the housing market. Interest rates influence the cost of buying a house and thereby the mortgage capacity of home-buyers. As the total housing stock is more or less given in the short term, a fall in interest rates will push up house prices. Over time this will in turn give rise to an increase in housing starts and thereby expand the housing stock.

A rise in house prices generally entails a corresponding increase in total wealth, as a large majority of Norwegian households own their own dwelling. Experience shows that an increase in wealth tends to translate into higher private consumption over time. For some households, it entails an opportunity to refinance their mortgage on more favourable borrowing terms, which in turn may result in higher consumption. Some may also finance other investments, such as purchasing a car or other consumer durables, by expanding their mortgage.

Chart 7
House prices
Index 1990 = 100



Source: ECON

A decline in interest rates generally entails an increase in household debt-servicing capacity, at least in the short term. Consequently, this also entails the risk of a weakening of households' financial situation when interest rates subsequently rise.

The twelve-month rise in nominal prices for existing homes was 11 per cent to the end of the fourth quarter 1996. Household housing wealth may be conservatively estimated at roughly NOK 700 billion, or roughly 7 per cent of GDP. The rise in house prices over the last year has thus provided households with asset gains of around NOK 70 billion. Over time, it must be assumed that these asset gains will translate into an increase in private consumption.

Similar mechanisms are also at work in other sectors of the economy, for example as regards the equity capital situation of business and industry and local government funding costs. Changes in interest rates will have an impact on the level of investment in the business and municipal sectors.

One indicator of private sector and municipal financial wealth, as well as the scope for raising new equity capital, can be the movement in share prices. Share prices on the Oslo Stock Exchange advanced by more than 30 per cent in 1996, the sharpest increase recorded on any European stock exchange with the exception of Helsinki and Reykjavik.

Such a sharp rise in asset prices may be associated with the risk of «financial bubbles», which means that the nominal value increase does not necessarily represent a corresponding permanent rise in the real underlying value of assets. This may thus reflect an unstable situation, with the risk that businesses and households overestimate their wealth in real terms, and become overexposed to debt.

Our models and other empirical material provide little guidance when estimating these and other effects of the changes in interest rates. This is partly because it is generally difficult to find stable relationships which can explain developments in financial saving and investment, and partly because extensive changes in the financial markets over the past decade make it difficult to draw conclusions on the basis of previous experience, especially prior to the dismantling of credit regulations in the mid-1980s.

Chart 8
Oslo Stock Exchange all-share index
January 1985 - January 1997

Source: Oslo Stock Exchange

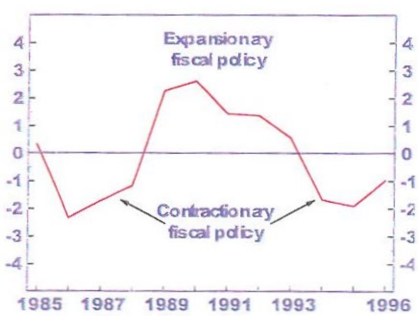
The interplay between fiscal and monetary policy

On the other hand, experience in Norway and abroad does provide a basis - albeit somewhat uncertain - for analysing the relationship between fiscal and monetary policy, and how these two components of economic policy have influenced cyclical developments over the past ten years.

Norway enjoyed a relatively healthy fiscal position at the end of the 1980s, partly thanks to the high level of oil revenues. This allowed an expansionary shift in fiscal policy in 1989, when our economy suffered a severe downturn. Measured by the cyclically-adjusted deficit, fiscal policy stimulated total demand by more than 7 per cent of mainland GDP in the period 1989-1992. Employment in the general government sector rose sharply, while fiscal policy also provided impetus to the private sector of the economy.

Despite an expansionary fiscal policy, however, the recession in Norway continued up to 1991 and unemployment did not peak until 1993, at around 6 per cent. Employment in the business sector did not pick up until 1994. One important factor behind this was the substantial consolidation of private sector debt. The expansionary impetus from fiscal policy,

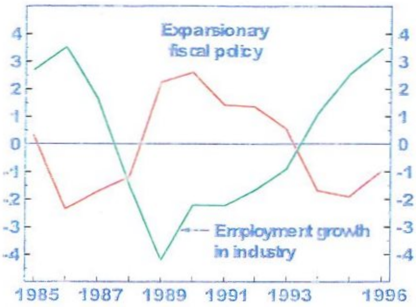
Chart 9
Changes in the cyclically-adjusted deficit
In per cent of mainland GDP



The orientation of fiscal policy is measured by changes in the non-oil, cyclically-adjusted deficit net of interest payments as a share of mainland GDP. Positive figures indicate an increase in the deficit and an expansionary fiscal policy. Negative figures indicate a reduction in the deficit and a contractionary fiscal policy.

Source: The Ministry of Finance

Chart 10
Fiscal policy and employment
In per cent of mainland GDP and annual percentage growth



The chart shows changes in the non-oil, cyclically-adjusted deficit net of interest payments (cf. Chart 9) and employment growth in business and industry. An expansionary fiscal policy has systematically coincided with a fall in employment (negative growth), whereas a contractionary fiscal policy has systematically coincided with an increase in employment.

Source: The Ministry of Finance, Statistics Norway and Norges Bank

Chart 11
Monetary policy
Index 1993 = 100

The overall orientation of monetary policy is calculated based on Norges Bank's Monetary Conditions Index (MCI). Real interest rates after tax are assigned a weight of 3/4 and the trade-weighted index deflated by relative price inflation is assigned a weight of 1/4. When the index is rising, monetary policy is expansionary, and conversely, when the index is falling, monetary policy is contractionary.

Source: Norges Bank

which would normally also have resulted in a rise in employment in the business sector, was more than offset by the debt consolidation.

The protracted period of debt consolidation was partly due to the orientation of monetary policy during this period. Like the other Nordic countries, Norway conducted a fixed exchange rate policy, where monetary policy was linked to interest rate trends in Germany and the rest of Europe. Due to the upswing following the reunification of Germany, German interest rates were very high at the start of the 1990s, with an associated rise in real interest rates in those countries whose currencies were linked to the Deutsche Mark.

When comparing trends in employment and the orientation of monetary policy, as measured by the Monetary Conditions Index, it seems fairly clear that in the past decade monetary policy has been consistently pro-cyclical.

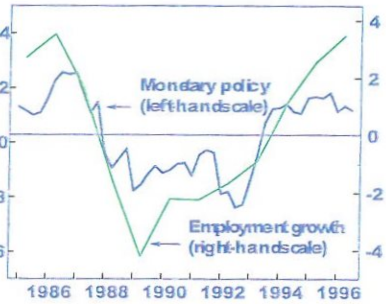
We may therefore observe that, on the whole, the orientation of monetary policy in Europe has entailed that the monetary policy stance in Norway has not been adapted to the cyclical situation in Norway. In the mid-1980s, the expansion in Norway was considerably more pronounced than elsewhere in Europe and price inflation in Norway was also higher. This entailed that real interest rates were low in Norway, and monetary policy had an expansionary effect. Towards the end of the 1980s and the beginning of the 1990s, the Norwegian economy was in recession, whereas the cyclical upswing in Germany pushed up real interest rates in Norway, leading to a contractionary monetary policy. Now Norway is again in a situation where its economy is in an expansionary phase of the business cycle, whereas sluggish growth in continental Europe is contributing to relatively low real interest rates and an expansionary monetary policy in Norway.

We may conclude that monetary policy in Norway has contributed to amplifying cyclical movements over the past ten years and has thereby largely countered the stabilising effects of fiscal policy. I think that it is fairly safe to say that this is still the case, after the recent sharp cuts in interest rates.

One question that may arise is whether monetary policy has not only amplified cyclical fluctuations, but has also been one of the main *driving forces* behind these cycles. This question is not easy to answer. Other elements, such as petroleum investment and export demand, also influence the business cycle in Norway. What seems to be fairly clear, however, is that the sharp changes in real interest rates must have played an essential role in amplifying both the cyclical upswings and downturns.

One element which may help to clarify this question is how interest-sensitive sectors have influenced swings in employment. I believe that developments in the construction industry in particular, which is one of the most interest-sensitive sectors, may illustrate this point. Employment in the construction industry rose by over 25 000 from the level prevailing at the start of the 1980s to 1987, and then fell by over 50 000 to 1993 when employment troughed.

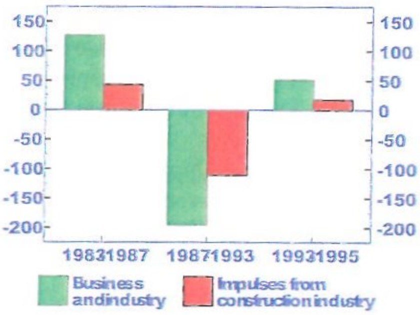
Chart 12
Monetary policy and employment
Index and annual percentage growth



The chart shows the index for monetary policy (cf. Chart 11) and employment growth in business and industry. By this measure, an expansionary monetary policy has systematically coincided with a rise in employment, whereas a contractionary monetary policy has systematically coincided with a fall in employment (negative growth).

Source: Statistics Norway and Norges Bank

Chart 13
Employment growth
In 1000 persons



Source: Statistics Norway and Norges Bank

We know from estimated commodity flows that a change in demand, which directly results in the employment of a thousand people in the construction industry, generates roughly 750 jobs in other sectors, primarily manufacturing, distributive trades and transport. The effects of fluctuations in the construction industry are therefore considerable. Taking these effects into account, the construction industry has accounted for 30 to 50 per cent of fluctuations in total private sector employment over the past fifteen years.

Before anyone draws any hasty conclusions on the basis of these comments, I would like to remind you that the *overall* relationship between fiscal and monetary policy must be seen in the light of the experience of the early 1980s. From this perspective, we could say that monetary policy has in many ways been successful over the last decade. We have succeeded in reducing inflation to a low level, the interest rate differential against other countries has been eliminated and cost competitiveness has improved. In other words, we have succeeded in re-establishing confidence in monetary policy, and the stable exchange rate has served as a nominal anchor for income settlements.

I would, however, argue that there is also a cost associated with this orientation of monetary policy. As we have seen, there is strong evidence that monetary policy has contributed extensively to amplifying cyclical fluctuations in Norway over the past ten years. It is neither novel nor surprising that choosing a stable exchange rate regime may give rise to such effects. Indeed, this must be one of the elements taken into account when weighing the pros and cons of various monetary policy regimes against each other.

A system with a stable exchange rate entails that fiscal policy must bear the responsibility for demand management. Fiscal policy has generally countered cyclical movements over the past ten years, and thereby had a stabilising effect. However, it is important to note that even the substantial and appropriate shifts in fiscal policy during the period were not able to prevent the relatively pronounced cycles.

A challenge

It seems clear that monetary policy will contribute to further growth in domestic demand in the period ahead. If the current orientation of monetary policy is allowed to feed through to the domestic economy, the cyclical upturn in sectors producing goods for the domestic market may prove to be even more pronounced and may be followed by a recession and a decline in employment. The experience of Norway and other countries has shown that such fluctuations in the economy can have lasting effects, such as a permanent increase in unemployment. Based on our experience of the interplay between fiscal and monetary policy, I think there is reason to highlight the challenge posed to fiscal policy by the current orientation of monetary policy.

This challenge is not diminished by the fact that fiscal policy has many other tasks. The economic framework for distribution policy and for the production of a number of public services is set through the budgetary process. In addition, the need to maintain economic efficiency and predictability places further constraints on the extent to which tax and benefit rates may be changed.

I must say that there are grounds for some concern regarding the difficulties involved in adapting fiscal policy to the cyclical situation, which arise precisely because fiscal policy has to be conducted under the influence of conflicting objectives. We all probably bear freshly in mind the tightening of the tax system in the 1980s, which was strictly necessary for the purpose of maintaining long-term balanced economic growth, but nonetheless was extremely badly timed as far as the business cycle was concerned. A parallel example could prove to be any reform in housing taxation, though this would not be of the same dimension as previous tax reforms. In view of the current orientation of monetary policy, however, any alleviation in housing taxes would certainly not serve to curb pressures in the housing market.

The session in the Storting last autumn revealed the difficulties our national assembly faces each autumn when weighing up various factors in an attempt to accommodate all the ambitions and objectives underlying the formulation of fiscal policy.

In my address last year, I emphasised the long-term challenges facing the Norwegian welfare state and the priorities required for the central government to carry out its responsibilities in the future. I attempted to point out a number of difficult long-term considerations linked to prioritising various public sector services, such as health services and pensions. These long-term challenges place constraints on the distribution of public resources in the future, and thereby also on the possibility of extensive shifts in overall fiscal policy.

Last year, I also sought to demonstrate that the objective of economic efficiency limits the scope for further increases in the general level of direct and indirect taxes. In terms of competitiveness, increasing importance seems to be attached to direct and indirect tax costs in a world characterised by the free flow of goods and services, and considerable cross-border capital flows.

Generally, it could perhaps be said that long-term considerations indicate the need for predictable and stable fiscal conditions. This places particular demands on the formulation of fiscal policy, which *also* bears responsibility for cyclical stability - an objective that indicates the need for wide variations in the orientation of fiscal policy. Obviously, it is not always easy to combine these two objectives.

An alternative approach could be to strike a balance between the aim of exchange rate stability and cyclical stability when formulating monetary policy. The aim would be to prevent monetary policy from amplifying cyclical fluctuations, so that the real economy and employment would be less prone to interest-rate shocks. Furthermore, the burden of implementing stabilisation policy could to some extent be shared between fiscal and monetary policy.

The primary drawback of a more active formulation of monetary policy is that the exchange rate would, to a greater extent, shadow cyclical fluctuations in the economy. In large countries where foreign trade accounts for a relatively small share of total GDP, changes in the exchange rate will have little effect on the general economy. Less emphasis can therefore be placed on exchange rate stability in large countries, whereas domestic stability must be assigned greater importance. In small countries with substantial foreign trade, changes in the exchange rate will be of greater importance, particularly in countries where export sectors also account for a high share of employment. It is, therefore, not possible to apply directly the experience of large countries with a relatively small share of foreign trade to small countries, like Norway, with an open economy.

I started out this evening by commenting that the central bank had followed the advice that Christian Michelsen allegedly gave to Bjørnstjerne Bjørnson: «Now we must keep our mouths shut!». This is of course a short-term strategy. The challenges at hand may make it just as natural to follow Bjørnson's advice: «Now we must stand united!»

First of all, we must recognise that *all* the three main pillars of economic policy are under pressure from various quarters. I have attempted to illustrate that although the krone is exposed to the most acute pressure, the problems are perhaps to the same extent related to the general stabilisation of the economy. In a system with a stable exchange rate, this is primarily the task of fiscal policy.

Furthermore, in our system of exchange rate stability, the level of the exchange rate is supposed to act as a nominal anchor for income settlements, in that wage growth has a direct and predictable effect on cost competitiveness. It is essential that the wage moderation approach is continued so that strong demand growth does not translate into rising wage and price inflation.

We must recognise, however, that the social partners have limited possibilities to enforce any agreement and that they cannot determine a general wage level with binding effect. The social partners primarily exercise their influence in the central wage settlements, whereas market conditions play a substantial role in local settlements. Although there now seems to be widespread recognition of the importance of wage moderation, growing labour shortages in various regions and among different occupational groups may have a substantial impact on wage and cost trends in the business sector.

I would like to underline that the operational guideline of a stable exchange rate stands firm. Norges Bank has oriented - and will continue to orient - monetary policy in accordance with the guidelines set out in the exchange rate regulation.

However, it is not always an easy task to maintain a stable exchange rate in a world where market evaluations of the krone may have a major impact. Although the central bank or others may argue and conclude that market perceptions are mistaken, it will not necessarily engender a correction in the market. In order to maintain the successful functioning of the system, monetary policy must thus be conducted with considerable patience, as regards the final objective.

Moreover, as I have tried to elucidate in my address, a stable, nominal exchange rate is no guarantee against swings in competitiveness or in the wider economy. To the contrary, experience shows that such a formulation of monetary policy may amplify fluctuations in the real economy and thereby increase the strains on fiscal policy and incomes policy. If other components of economic policy do not sufficiently restrain the expansionary impact of monetary policy, pronounced demand cycles will sooner or later fuel domestic price and wage inflation, with an associated deterioration in competitiveness and subsequently, the basis for employment.

For a system of exchange rate stability to function as intended, it is thus a pre-condition that the authorities succeed in maintaining overall economic stability relying on instruments other than those of monetary policy.