# Economic Perspectives

*Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 18 February 1993*

Throughout the postwar period Norway has attached considerable importance to maintaining a stable trend in the real economy. Thanks to the room for manoeuvre provided by oil revenues Norway was able to manage this longer than most countries. Declining price stability relative to other countries was partially remedied with the help of minor and larger devaluations. Following the sharp fall in oil prices in 1986 the central government no longer had sufficient financial resources to continue this approach. At the same time, the agreed reduction in working hours resulted in a dramatic deterioration in cost competitiveness. The situation forced a new devaluation, by as much as 9 per cent.

Experience from this period demonstrated that devaluations did not provide a lasting solution, and a stable exchange rate level has since 1986 been a cornerstone of policy. As this policy gained credibility, interest rates were reduced to the levels in other European countries, and price inflation fell to a new low, both compared with earlier years and with other countries. Furthermore, Norway's competitive position has improved since 1988. Expectations grew that eventually we would achieve a more stable real economy on a sounder basis than previously.

The international currency turbulence in the past year shattered this cornerstone and we do not know when it can be restored. It may be natural to begin by an attempt to shed light on the international background for recent events. Since Norway has been so strongly influenced by developments in the other Nordic countries, it may be useful to examine these countries in particular.

Our inability at the moment to conduct a traditional fixed exchange rate policy does not mean that stability should be discarded as a basic policy guideline. In this connection it is highly relevant to examine the extent to which policy is geared towards preserving stability and its guiding principles. This will be the key subject of my address this year, and it is natural to consider in particular the role of the central bank. Finally, I will discuss the basis for re-establishing more stable trends and the demands this will make on economic agents in the society.

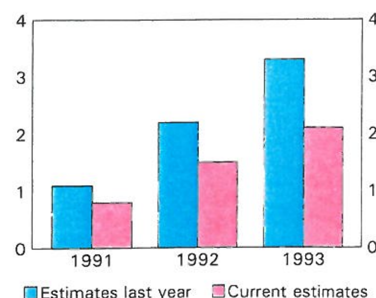
## 1992 - a year of new disappointments

One year ago growth in the OECD area was expected to accelerate in the course of 1992 and then gather momentum this year. Today, it appears that growth in 1992 will not be much higher than in the preceding year, and expectations for 1993 are barely what they were for 1992. We are still pinning our hopes on the second half-year and next year.

Little can be added to what I said last year concerning the reasons for sluggish growth:

- A continued need for debt consolidation, particularly in the US, Japan and the UK.
- A high long-term interest rate level, especially because the financing of government deficits absorbs a very high share of saving.

**Chart 1**
**GDP growth in the OECD. Per cent**

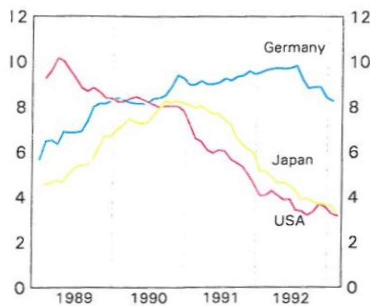



The international economic upturn has been slow to materialise. GDP growth in the OECD area was 1.5% in 1992, while the estimate one year ago was 2.2%. The estimates for 1993 have also been revised downwards from 3.3% one year earlier to 2.1%.

Source: OECD

– A high short-term interest rate level in Europe as a result of Germany's need to employ monetary policy to reduce inflation.

**Chart 2**
**Short-term interest rates. Per cent**




Three-month rates in Germany have been kept at a high level the last few years to reduce inflation. In the US and Japan, on the other hand, three-month rates have been substantially reduced the last two years to spur economic growth.

Source: Norges Bank

It may appear as though the industrialised countries have adopted a rather passive stance for coping with the recession, but that would be an oversimplification of the situation. The two largest countries have, in fact, done a great deal. Since the end of 1990 the US has continuously eased monetary conditions, both to boost demand directly and to strengthen the position of financial institutions. The effects on the real economy have been slow to materialise, but they are now becoming more evident. Since last spring Japan, in addition to lowering interest rates, has adopted several fiscal packages to spur the economy. It takes time, though, for the effects to feed through to the economy. Japan is, however, the only country that has any significant degree of fiscal room for manoeuvre after having taken advantage of the prolonged period of expansion in the 1980s to strengthen government finances. The OECD countries as a whole reduced public sector budget deficits by only one per cent of GDP in the period 1979-1989, while in the following years up to 1992 they again grew as much as three per cent. This does not provide much leeway in fiscal policy.

## Crisis or slow growth?

"The upturn which never materialises" has raised the question of whether the world economy is heading towards a depression like the one experienced in the 1930s. There are several reasons for believing these fears are exaggerated:

– What we are now experiencing is stagnation whereas there was a general decline in output at that time.

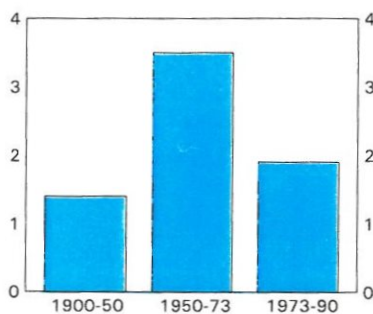
– Today the authorities would not permit a crisis to spread through a collapse of the financial sector as was the case then.

– The social safety net is better developed and dual-income families are far more common.

– A relatively stable public sector plays a far greater role today than it did then.

– New growing economies, particularly in southeast Asia, are not experiencing any form of stagnation and are generating a stimulus to the economies in the West.

**Chart 3**
**OECD - GDP growth per capita. Per cent**




The period 1950-1973 stands out with particularly high growth; GDP growth per capita in OECD countries was then as much as 3% annually. In the following period growth has been about 2%, while it was 1½% in the period 1900-1950.

Source: OECD

A more timely question may be how much growth we can reasonably expect in the most developed countries in the longer run. Our generation is apt to use as its point of departure the experience from the protracted upturn from 1950 to 1973 when annual output growth per capita in the OECD area was as high as 3½ per cent. Compared with this a growth of only 2 per cent after 1973 is not much to boast about. If, however, we look at the period prior to 1950, we find that in the first half of this century the corresponding growth was about 1½ per cent and even this is high compared with earlier periods. From this perspective it is perhaps the period 1950-1973 which is unique and requires an explanation. It is natural to focus on two factors in particular:

– The liberalisation of world trade provided a basis for a far more extensive division of labour resulting in economies of scale.

- There was a sizeable catch-up effect for all countries that could import technology from the US, particularly Japan which both had much to gain and a strong capability and will to do so.

These two factors reinforced one another because technology transfers partly took place through the liberalisation of trade and direct investment.

These are once-only occurrences which cannot be repeated in the western industrialised world. On the other hand, we see the same phenomena recurring in the relationship between Japan and southeast Asia and it could also conceivably occur between western and eastern Europe and between the US and countries in South and Central America. For Norway, it will entail both keener competition and larger markets.

More moderate growth does not necessarily have to result in rising unemployment because demand is increasingly focused on services for which productivity gains - at least given the way these are measured - are lower than in goods-producing sectors. And a doubling of real income over 30-50 years should provide ample opportunities for welfare improvements. Lower growth and a somewhat slower pace of restructuring in the society may also make some of the problems confronting us easier to solve. What is worrying today is that so many people cannot find employment, with the result that growth is substantially lower than even a more moderate level of ambitions would imply.

In retrospect we can see that these exaggerated notions about stable high growth resulted in serious fiscal imbalances for a number of countries in the period following the first oil crisis. They were gradually compelled to reorient fiscal policy in spite of continued high unemployment. Norway was able to postpone this adjustment because we could draw on oil revenues, whether they were those we expected or what we actually had. Now, however, we too have exhausted our options and can no longer base growth and employment on government stimulation of demand. Other countries have previously had to embark on the far more difficult path of adopting structural policy measures to improve the functioning of the economy. To some extent they have also been successful despite the resistance of strong interest groups.

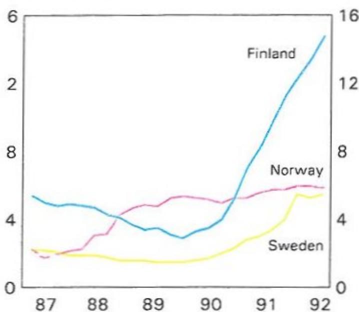
## The demise of currency stability

The single market and the EEA agreement were part of this structural policy. The Maastricht Treaty was to add a new dimension to the co-operation, including even closer co-operation in exchange rate policy. Economic and Monetary Union is perceived as the very foundation of currency stability in Europe. By linking the Norwegian krone to the ECU, we also attempted to build on this, independent of the issue of Norway's accession to the EC.

The long period since 1987 with no general exchange rate realignments might have exaggerated the impression of economic convergence between countries. Substantial progress was indeed made in this respect, but over time considerable tensions still emerged. The policy for the anchor currency, the Deutsche Mark, which primarily safeguarded domestic interests, did not help to reduce these tensions. A narrow "no" vote in the Danish referendum on the Maastricht Treaty and an almost equally narrow "yes" vote in France demonstrated that grass root feelings differed from those at the top. Confidence in the very foundation of the exchange rate system thereby faltered, and half of the currencies which participated in the ERM have later been devalued or allowed to float.

Even though the turbulence this autumn in European foreign exchange markets may seem dramatic, it is important to bear in mind that the ratification process for the Maastricht Treaty is still in progress. The EMS as we know it today is strictly speaking not dependent on this treaty. It is therefore too early to write off the EMS or the possibility of relinking the krone to the ECU, if that is the solution we consider to be in our best interest when we are in a position to return to a fixed exchange rate system.

**Chart 4**
**Unemployment. Per cent**




Unemployment, measured as a percentage of the labour force, has risen sharply in Norway, Sweden and Finland the last few years. It has risen most in Finland. In Sweden it is expected to continue to rise in 1993 and 1994. The figures in the chart are standardised, corresponding to the Norwegian LMS figures.

Source: Central Bureau of Statistics and OECD

The currency unrest in western Europe last year was actually a corrective response to economic fundamentals, and the realignment should have taken place earlier and in a less disruptive fashion. Still, this is no reason for abandoning the earlier perception that we will all be best served by the creation of a new and sounder basis for the re-establishment of fixed exchange rates. The real economic arguments for exchange rate stability are just as valid as they were before.

## The Nordic countries - a turbulent area

Even though our own float was ultimately triggered by the currency turmoil in Europe, developments in our neighbouring countries were just as important for the decline in confidence in the Norwegian krone. Throughout the 1970s and the first part of the 1980s Sweden, Finland and Norway were looked upon as reasonably successful examples of countries that could maintain high growth, low unemployment and, at the same time, avoid strong inflation.

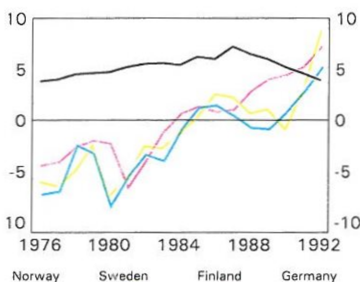
This situation was reversed in the course of a very short time.

- Unemployment rose sharply, first in Norway but gradually even more in Finland and Sweden.

- Fiscal policy was poorly managed. Sweden and Finland are experiencing very severe fiscal difficulties. In Norway, the renewed increase in oil revenues has temporarily diminished this problem.

- Enterprises and households did not manage to cope with the steep rise in their debt obligations, and the financial system was threatened with collapse.

**Chart 5**
**Real after-tax interest rate. Per cent**




The real after-tax interest rate on household loans was negative in Norway, Sweden and Finland up to the mid-1980s, while in Germany it has been stable and positive throughout this period. The real after-tax interest rate is determined by the nominal interest rate, inflation and the tax treatment of debt interest. Finland has an upper limit on tax-deductible interest charges, and it is uncertain how many are affected by this ceiling. The figures for Finland are therefore very uncertain, and for illustration purposes a tax rate of 50% throughout the period has been assumed. In Germany households are generally not allowed to deduct interest payments from income for tax purposes.

Source: Norges Bank, Sweden's Riksbank and Bank of Finland

A pertinent question is whether there are any common underlying reasons for the unfavourable developments in these three Nordic countries, and abroad this question is raised particularly in connection with the banking crisis. The spotlight is no longer solely focused on Norway after we were joined by our two neighbouring countries.

The banking crisis did not only hit the Nordic countries. However, with the exception of the special measures the US has been forced to adopt for its savings and loan associations, it is in the Nordic countries that the crisis has deepened to the extent that the central government has become heavily involved. It appears that the costs of the financial crisis for the Treasury will be even greater in our neighbouring countries than in Norway.

Deregulation in the 1980s, which increased competition, reduced the banks' profit margins and opened up new borrowing opportunities, provides a general explanation for the international banking crisis. The banking system of other European countries on the continent experienced very few of these structural changes and thus had no real banking crisis, even though weak cyclical conditions also had an adverse impact on the banks

there. The situation in Norway, Sweden and Finland was exacerbated by one additional factor: extremely low borrowing costs as the result of different combinations of tax rules, a policy of low-interest rates and inflation. The credit market was deregulated without bringing real after-tax borrowing costs up to a realistic level, thereby providing a basis for vigorous lending growth with an accompanying boom. The recession deepens when the private sector wants to pay off its debt and borrowing costs are increased at the same time. In Norway, the recession began at a time when the world economy was still moving on an upward trend while the Swedes and Finns were not so fortunate.

Whereas the recession in Norway was triggered by the fall in oil prices, the collapse in trade with the eastern bloc halted the upturn in Finland. The upswing continued a little longer in Sweden, but the debt bubble common to all three countries also amplified the recession there when it came. It exposed fiscal problems that had existed throughout but which had been concealed by a sharp growth in income. In Norway the reduction in government wealth is not as apparent because of the large and increasing oil revenues. Excluding these revenues, Norway's government budget deficit is not much different from that of our neighbouring countries.

An economic upturn will alleviate the problem but will not eliminate it. The structural deficit will still exist. This indicates that the public sector has undertaken greater obligations than what can be financed in a sustainable manner.

Interest payments on a growing government debt will displace other public sector tasks and when fiscal tightening can no longer be avoided the markets will expect the government to resort to devaluation to reduce real wages and thereby improve competitiveness. The possibilities for raising new loans in local currency are thus reduced and the expectations themselves force the devaluation. Large and growing public sector deficits are therefore a certain route to declining currency stability.

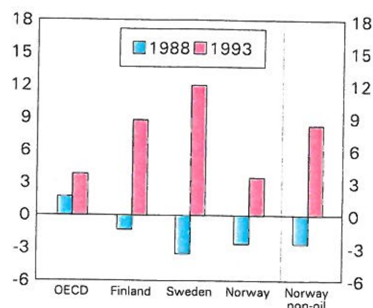
## Restoring balance - for whom?

Experience in both our neighbouring countries and in Norway shows how important it is to create the basis for stability while the economy is expanding, even though it may be difficult to stop the bandwagon. An imbalanced situation cannot be stable. Some kind of equilibrium must be restored and it was this task we set out to accomplish in 1986. However, we were not prepared for the sharp rise in unemployment which occurred, and in 1989 fiscal policy was revised in an expansionary direction.

Even so there has been virtually no output growth in the Mainland economy during the last four years. Production in the oil sector, on the other hand, rose sharply and alone contributed to an annual income growth of 1.7 per cent for Norway. This has been offset, however, by a deterioration in our terms of trade, and real disposable income for the country as a whole has thus expanded by less than 1 per cent a year.

In spite of the very low increase in the country's income, both households and municipalities - and to some extent the business sector - have recorded a rather sharp growth in real income through the period. Excluding the central government, other domestic sectors have seen their real disposable income rise by a good 3 per cent annually. Households have accounted for about half of this, while municipalities and the business sector have split the remainder. Household real disposable income grew by nearly 10 per

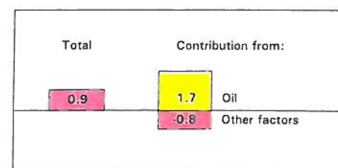
**Chart 6**
**General government budget deficits. Per cent of GDP**




In the past few years government finances have deteriorated far more in Norway, Sweden and Finland than in the OECD as a whole. The situation is worst in Sweden where general government budget deficits have risen by about 15% of GDP in five years. In Norway a sharp increase in government oil revenues limited the weakening of the budget, and the deficit for the public sector is now approximately on a par with the OECD average. Figures for the public sector have been used in the chart in order to present internationally comparable figures. Figures for the central government sector alone would have produced a very similar picture. In Norway and Sweden local government budgets have strengthened somewhat over the period, while in Finland there appears to have been a deterioration.

Source: OECD and Ministries of Finance in Norway, Sweden and Finland

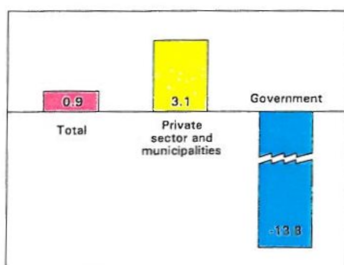
**Chart 7A**
**Growth in real disposable income Average 1988–1992. Per cent**




Norway's real disposable income rose by 0.9% annually from 1988 to 1992. Higher oil revenues alone have contributed to boosting income by 1.7% a year, but this has been offset by a deterioration in the terms of trade for other goods.

Source: Central Bureau of Statistics and Norges Bank

**Chart 7B**
**Growth in real disposable income by sector. Average 1988–1992. Per cent**




In spite of the weak growth in income for the country as a whole, households, municipalities and the business sector have recorded an annual growth in real income of 3.1% in the period 1988-1992. The offset to this is a sharp deterioration in government finances, with a decline in real disposable income for the central government sector of as much as 13.8% a year.

Source: Central Bureau of Statistics

cent in these four years, and the growth for what we often call an average wage-earner was almost as high, or about 8 per cent.

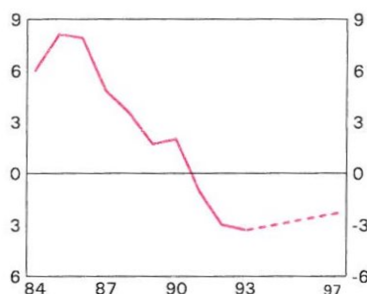
With all these groups posting income gains and the country's real income showing only a very moderate rise, there must be a loser. The loser is the central government sector whose revenues after net transfers to other sectors have been almost halved. This means that government transfer payments were equivalent to about 7 per cent of the country's total income in 1988. This is mirrored in rising budget deficits.

The private sector and municipalities have used a high share of these transfer payments to strengthen their financial position. At the same time, the central government's position has deteriorated. This shift in assets may have its economic advantages but the problem is that neither the private sector nor municipalities are prepared to relinquish the stronger income position they have gained in relation to the central government. The central government therefore continues to accumulate debt while the private sector is building up its financial assets. Interest payments will therefore lay claim to a rising share of government revenues. In the years to 1997 these interest payments are expected to increase by an amount equivalent to all other government spending combined. From a welfare point of view the way in which we have solved the private sector's balance-sheet problems is perhaps not ideal.

## On the path to growing realisation?

A four-year period with rising real income for households without any counterpart in the real economy other than a greater use of our oil wealth does not bear witness to any great progress in solving our long-term problems. There are nevertheless signs that the problems have been recognised more clearly than earlier, and to some extent this recognition has also resulted in practical action.

**Chart 8**
**Central government budget balance. Per cent of GDP**




As a result of the expansionary fiscal policy since 1988, central government finances have deteriorated sharply. The central government budget deficit, based on national accounts definitions, is estimated at 3.3% of GDP for 1993. The Government's Long-Term Programme calls for a reduction in the deficit to 2.3% of GDP by 1997.

Source: Ministry of Finance

The government budget for 1993 was drawn up with the aim that underlying spending growth was not to exceed the projected growth in the Mainland economy in the medium term. This was not fully achieved, but the approved budget - unlike previous ones - was not intentionally expansionary. The original strategy for the government budget has been maintained in the Long-Term Programme. It is now generally recognised that the government budget can no longer be used to stimulate demand in order to increase employment.

The reduction in employers' social security contributions in return for a higher VAT rate is further recognition of the need to boost business profitability in order to enhance employment. It is now the task of enterprises and the social partners to ensure that the change actually improves earnings and does not result in higher wages. In the short term a higher profit share will affect the level of real wages. This must be accepted by the employed in order to give the unemployed a better chance, and it should be seen as a correction of the strong increase in real income the past few years which we basically could not afford.

Through the Employment Commission broad acceptance was gained for the premise that higher employment presupposes an increase in the number of jobs in market-oriented industries, and that this necessitates a continued improvement in competitiveness. Any quantification of the necessary improvement in competitiveness will be somewhat arbitrary. What is essential is that there is a change in labour market and business sector

behaviour which puts us on the path towards improved competitiveness. We must adhere to this principle until unemployment is reduced to a level we can live with and there is an acceptable balance in the economy also when taking into account that we are drawing on oil wealth.

We will thus have three important principles to adhere to when formulating economic policy: Balance in public sector budgets must be strengthened and, in any event, not be weakened; employment is more dependent on improved earnings for enterprises than for households; and the rise in costs in Norway must be lower than in competing countries in the years ahead. These principles, however, do not provide scope for easy solutions.

## Fixed exchange rate and floating exchange rate

In one way these basic premises were embodied in the fixed exchange rate policy, although its implementation could indicate that they were not fully grasped. For a period we were able to conduct an expansionary policy with rising government borrowing. As I have already mentioned, the experience of our neighbours showed that a rising borrowing requirement shatters the foundations of a fixed exchange rate policy. In view of Norway's high cost level, the strengthening of competitiveness aimed at increasing business profitability was a prerequisite for maintaining a credible rate of exchange.

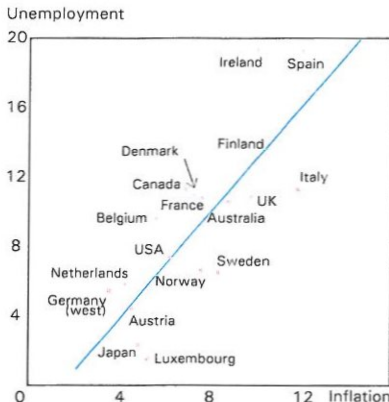
But Norway did not come out unfavourably compared with other countries with a fixed exchange rate policy. Conditions extraneous to the Norwegian economy forced the decision to float the krone on 10 December.

As a result monetary policy was no longer subject to the constraint of durable balance inherent in the fixed exchange rate policy. Demands have been raised that the new-found freedom of action should be used to conduct an interest-rate policy that best suits our domestic needs. Lower interest rates are generally considered to be favourable, and the lower krone rate it would entail would strengthen competitiveness. The intentions behind the demands may be good enough. However, they do not testify to a deep understanding of how a floating exchange rate functions. In any event, there are good reasons to be sceptical about solutions that enable one to have it both ways.

It may be useful to recall that capital movements remain liberalised and that financial assets move towards the highest returns, whether in the form of high interest rates or exchange rate appreciation. If interest rates are lowered, funds will progressively be switched out of krone positions, and when Norges Bank does not intervene, the krone exchange rate will fall. The depreciation will continue until the central bank is expected to raise interest rates and purchase kroner to increase the exchange rate. Market participants will thereby benefit from the rise in the exchange rate. If the expectations are not fulfilled, the exchange rate will continue to fall until it reaches a level low enough to generate widespread expectations of intervention on the part of the authorities to halt the decline.

It is impossible to identify a specific exchange rate or level of interest rates which will establish reasonable stability for the currency. What we do know is that the uncertainty involved has its own price in the form of higher interest rates because the fear of losses outweighs the prospect of gains. Furthermore, if confidence is too weak to maintain a new exchange rate level, for example because the exchange rate has been allowed to fall to a level where prices and wages are drifting upwards, further pressure will be exerted on interest rates. Therefore, for a small country a floating

**Chart 9**
**Inflation and unemployment. Inflation in per cent 1974-1992, unemployment in per cent of the labour force 1993**




The chart illustrates that the countries which have had the highest inflation in the period 1974-1992 seem to have the highest unemployment today. The plotted line is calculated by linear regression.

Source: OECD and Norges Bank

exchange rate can only bring interest rates down for a very short period. Large countries stand more to gain from a floating rate system. Since imports are less important, the impact on prices is less significant and transactions in domestic currency play a more dominant role in the domestic economy.

The floating exchange rate regime in Norway does not mean that the authorities can leave things to the market and refrain from adopting a monetary policy stance. The central bank will have to set interest rates which determine rates in the money market, which in turn will influence the exchange rate level and its movements. The question is therefore what the objectives of monetary policy should be.

## Price stabilisation as a guideline

In recent years Norway has managed to bring inflation down to a level slightly below the European average, a level that has not been seen since the beginning of the 1960s. Some people argue that this has been achieved at considerable costs to the real economy. But a more inflationary policy would have created expectations of a return to the devaluation approach. Some have even recommended this. Interest rates would then have been higher for a long period ahead. It is difficult to see what the benefits of such an approach should be, be it for the business sector or for heavily indebted households.

Others claim that although our options are limited since other countries have chosen to pursue an anti-inflationary policy, the world economy as a whole would be better served by settling for a higher inflation rate. But there is no empirical evidence suggesting that growth would increase with higher inflation. To the contrary, in the period 1960-1990, growth rates have been highest when inflation has been at its lowest.

Another and perhaps better basis for assessing the relationship between inflation and unemployment is by comparing countries. Our comparison is confined to the OECD area. Inflation rates after the oil price rise, that is in the period 1974 -1992, are compared. The figures for some countries are lacking and Iceland and Greece, two high-inflation countries, have been excluded. OECD unemployment estimates for 1993 are used. With the exception of the Nordic countries, the picture would essentially have remained the same if average unemployment had been used in the period covered. And with respect to the latter, their solution to unemployment involving increased public spending has not proved to be a lasting one.

There is a rather clear indication that unemployment is lowest in the countries with the highest price stability. Several time periods have been used and the least that can be said is that nothing indicates that the countries that have accepted a higher rate of inflation have achieved any employment gains.

This does not prove a causal relationship between price stability and employment, although there are good reasons to assume a relationship of the kind indicated in the chart. In a low-inflation environment planning is less affected by uncertainty, interest rates are less volatile and the need for significant adjustments in economic policy is reduced. Conversely, there seem to be few arguments based on economic theory suggesting that a durable increase in employment can be achieved by accepting a higher rate of inflation. The required rate of return and wage formation will be adjusted to inflationary expectations. The economic and distributional effects will

therefore be the same as in an environment of expected price stability. In effect, it is only through steadily stronger inflation that one for a limited period can achieve a boost in demand that results in higher employment. But such a development will eventually lead to the collapse of the monetary system, with dramatic consequences for the real economy.

On the other hand, it is true that whether the objective is to control inflation or improve the external account or budget balances, a tightening of demand will involve some cost to the real economy during the period this tightening takes place. But once these costs have been incurred, it would be tragic to relinquish the gains achieved and accept a higher inflation rate which would have to be brought down after some years at renewed costs to the real economy.

Although there is a strong case for having price stability as an objective, in practice a stable price level is not necessarily defined as zero price growth. The Chairman of the Federal Reserve, Alan Greenspan, expressed this in the following way:

> "For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household decisions."

This definition is commonly accepted in the central banking community. In the Long-Term Programme the budget projections are based on the assumption of an annual price rise of just below 2 1/2 per cent, which is probably close to being within the limits of this definition.

In practical terms stabilisation of the price level has already for some years been the policy guideline for Norges Bank's implementation of monetary policy. Since 1986, the krone has been maintained at a stable level in relation to a basket of currencies of countries whose monetary policy has increasingly been geared to serving the objective of price stability. In 1990 the krone was linked to the ECU which was perceived as an ambitious move since the EC had defined price stability as an even clearer long-term objective of monetary policy. Stability in relation to these currencies therefore implied that Norway also geared its policies towards price stabilisation.

When a floating exchange rate is adopted as a result of strong market pressures, the associated depreciation will increase import prices and thereby also the general price level. This is difficult to avoid, but it is important to stabilise the price level again as early as possible. This requires that wage compensation be avoided and that the resultant improvement in competitiveness and business profitability is rather seen as added support to employment.

During the period that we were able to maintain a fixed exchange rate, confidence in the credibility of this policy as a permanent feature gradually improved. It is also my impression that the decision to float the krone is perceived as a measure we were forced to adopt due to external factors. This would hardly have been the case if we had yielded to the pressures as soon as Sweden decided to float its currency. The interest rate differential against the ECU component currencies has shown a downward trend and is now down to 0.6 per cent, which indicates that this confidence has largely been preserved.

Confidence can only be achieved through the policy conducted. But the floating of the krone also means that the exchange rate may be changed,

and the stronger the pressure is on the monetary authorities to adopt a policy of accommodation, the stronger the fears of concessions will be. This makes it even more important now than under the fixed exchange rate regime both to assert and show that price stability is still the long-term objective of monetary policy.

This can in fact be implicitly understood from the Government's statements concerning exchange rate policy. In his statement to the Storting (the Norwegian parliament) on 11 December the Minister of Finance stated that "Norges Bank shall in its conduct of monetary policy place emphasis on establishing a new fixed exchange rate level for the krone as soon as international conditions permit". But in order to establish a credible level, market expectations must be that price stability is at least in line with that of the other countries adhering to the same exchange rate system.

## Exchange rate policy and the central bank's position

The Act on Norges Bank states that the central bank "shall conduct its operations in accordance with the economic policy guidelines laid down by the government authorities." After a stable exchange rate was stipulated as the main objective of monetary policy, Norges Bank's task has been to use liquidity policy instruments and establish interest rates in its transactions with the banks to serve this objective. Of course this is done in consultation with the Ministry of Finance, but both formally and in practical terms Norges Bank is responsible for the decisions taken. In this respect the central bank has in practice had the same degree of independence as other central banks whose task is to maintain a fixed rate of exchange.

The guidelines presented by the Minister of Finance to the Storting after the krone was floated were drawn up in consultation with Norges Bank. They have presented no problems with regard to the central bank's implementation of monetary policy. Nevertheless, it is more difficult to elaborate guidelines for the central bank under a floating exchange rate regime which are equally precise as with fixed exchange rates. Other countries that have a longer tradition of floating exchange rates have chosen different solutions to give the central bank a political mandate.

In Germany legislation stipulates that the Bundesbank's main task is to safeguard the value of money. Swiss legislation defines the tasks of the central bank so broadly that the central bank itself has stipulated price stability as a priority. In Canada and New Zealand a formal agreement has been concluded between the minister of finance and the central bank governor on the price stabilisation to be achieved, and the central bank governor is responsible for achieving it.

Since the floating exchange rate regime is meant to be temporary, it does not in itself require a change in the institutional framework for Norges Bank's operations. A shared understanding of the significance of price stability in resuming a credible fixed exchange rate policy seems at this stage to suffice to give the central bank the needed margin of manoeuvre. However, the central bank must have the same instrumental freedom as under the fixed exchange rate regime in order to gain market confidence in the policy guidelines that have been laid down.

In the event of Norway's accession to the EC, the central bank's independent position will have to be stipulated in legislation. However, the plans for monetary union entail that the central bank's independence is exercised through the European Central Bank and it is this bank's independent position that will be of decisive importance also for us. But it can only use its

independence to execute the tasks assigned to it by the member states' elected bodies, notably to preserve price stability. No central bank is free to determine political priorities. Independence is confined to applying a central bank's instruments.

As such, a statutory provision for Norges Bank's independence will hardly affect the actual operations carried out by the central bank. The spectrum of policy instruments is in fact quite limited once the objectives have been formulated, irrespective of who the decision makers are.

Even if Norway does not accede to the EC, there is therefore little reason to refrain from following the trend prevailing in the countries with which we have close economic and political ties and that have policy objectives similar to our own. When the exchange rate regime and level are set by the Government, the central bank's task will be limited to the practical implementation of the established policy. The legal definition of the central bank's position may not be of much significance in this context. However, if Norwegian legislation in this area is unique, it gives the impression that we are retaining the possibility of deviating from a stability-oriented policy. This would weaken market confidence and entail higher costs in the form of higher interest rates. As the government progressively becomes a net debtor, the price of maintaining a possibility for political control over the central bank could place a noticeable burden on the government budget.

## What should be stabilised?

So far we have examined stability and stabilisation as if they were two clearly defined concepts. Only in the case of price stability, have we tried to be a bit more precise. Before rounding off the discussion it may be worthwhile to examine stabilisation as a more general concept and the constraints facing us.

Stabilisation is not an objective in itself. The goal is to ensure that the key economic aggregates provide business, households and municipalities with a realistic basis for their planning. This is a pre-condition for optimising the allocation of resources.

Price stability is also a prerequisite for having a value reference for planning purposes. Furthermore, price stability enhances the stability of interest rates. The same applies to a sound budget balance because the risk of substantial changes in government benefits and taxation is reduced.

However, not all aggregates can be expected to remain stable. The economic system must be sufficiently flexible to provide for unexpected circumstances which may arise and permit measures to be taken which can keep key aggregates on the right track. This means that we have to tolerate short-term deviations from stability in order to maintain stability over a longer term. The long-term perspective must take precedence over the short term just because it lasts so much longer. The conflict is latent in most of what we do. When a goal is to be achieved both in the short and long term, the long-term goals yield way to short-term considerations because the latter come first.

Since most agents are interdependent, no one single agent can alone assume responsibility for stability over a longer period of time. The central bank can conduct a policy with a view to stabilising prices but without the support of budget policies and the social partners the real economic cost of this policy could be so large that the central bank loses its political man-

date to conduct it. The government can conduct policy with the aim of achieving high and stable employment, but if the wage level and wage flexibility are not geared towards the same end, the government's resources will quickly limit the scope for pursuing this policy. Even if the government will always have a role to play in optimising the functioning of the labour market, the business sector and the social partners will through their behaviour determine the level of employment that is compatible with a stability-oriented policy. But this behaviour will in turn be influenced by the actions of the government. A moderate line can be difficult to pursue if the government's spending policy involves rising tax rates.

Balanced growth in the real economy, which is the goal of stabilisation policy, is contingent upon a realistic approach and the willingness to co-operate of all parties involved, but also a realistic perception of this willingness to co-operate.

## The opportunities at hand

At first glance it may seem that today's situation is not the best basis for conducting a stability-oriented policy. I believe, however, that a number of fundamental conditions are in place:

- Inflation is low and there is little pressure in the domestic economy.
- Wage earners have experienced a number of favourable years and should be able to tolerate some decrease in real income.
- The financial sector seems to have overcome the worst of the crisis, although the commercial banks still have a long way to go before they can fulfil their function in a satisfactory manner.
- The balance of payments is in surplus and oil and gas production will continue to rise over the next years.
- It is still permitted to hope that the world economy will recover in 1993.

But if we are to turn these positive aspects to account so that they yield a stronger economy and higher employment a number of conditions must be satisfied.

- Increased business revenues as a result of a reduction in the level of employers' social security contributions and a fall in the krone exchange rate must be translated into increased profitability rather than higher wages. These factors can thereby secure jobs and widen the scope for expansion.
- The fall in the exchange rate must not be allowed to go so far that moderate nominal income growth is impossible to achieve. This must be given special emphasis in the implementation of monetary policy.
- The need to reduce the budget deficit will remain and even be greater if the float increases interest payments on government debt.

There is no reason to deny that the transition to a floating exchange rate is a setback for the fixed exchange rate policy conducted since 1986. On the other hand, the decline in the exchange rate does provide scope for achieving some gains. But if the float is used to adopt a more lenient policy approach, the gains will be jeopardised and we will be left only with what we have lost.

The possibility of turning losses into gains depends on our determination and ability to allow long-term stability to establish the direction of the path we choose. This path has been adequately marked out, and we are well aware of the deviations that lead us downhill. The task now lies in persevering in the course we choose to take and not leave the task of returning to this path to future generations.