Economic Perspectives

Address by Governor Torstein Moland at the meeting of the Supervisory Council of Norges Bank on 10 February 1994

A mood of optimism has gradually returned to the Norwegian economy after years of pessimism and difficulties in many areas. It is tempting at such a point to breathe a sigh of relief and enjoy the prospect of the recovery ahead. While such a response may be understandable, it is not entirely justified.

In Europe unemployment has been edging up since the beginning of the 1970s, and this trend has also gradually spread to the Nordic countries. Although economic growth has generally been lower in the past couple of decades than previously, this is not the only explanatory factor. Structural features and conditions in national labour markets and the world economy have also played their part.

It would be wrong to assume that we are dealing with purely cyclical phenomena that can primarily be tackled by demand management. Even less is the answer to be found in the direct controls of the past. The open Scandinavian economies would be among the most vulnerable if this approach were to gain support.

It is not the central bank's responsibility to formulate, or implement, a coherent economic policy. Nor is it the central bank's task to admonish the politicians and social partners - although we are expected to call attention to undesirable developments and problematic options.

Our responsibility is to analyse the economic consequences of different decisions and policy choices, and function as an independent adviser. We are charged with specific tasks in the implementation of monetary and exchange-rate policy and with ensuring that financial and foreign exchange markets function smoothly. This is the basis for Norges Bank's activity and it will be the subject of this address.

Monetary and exchange-rate policy is in a period of transition. Just over a year ago, when the krone was floated, it was assumed that the situation would be short-lived, soon to be replaced by a new regime of fixed exchange rates. This was not to be, and we must now be prepared for the krone to float for a long time to come. This poses new challenges to monetary and exchange-rate policy. It also raises a number of questions of principle about the role of the central bank, which I will elaborate on by way of conclusion.

The recovery is under way

After several years of stagnation in the Norwegian economy, 1992 and 1993 saw an expansion of Mainland GDP. The pace of expansion quickened in the second half of last year, and all forecasts and current indicators for the Norwegian economy now point towards a continued upturn.

The continued rise in general government consumption is now being accompanied by appreciable growth in private consumption and investment, and the rate of housing starts is increasing. While these are the main factors behind the upturn in the economy as a whole, exports also seem set to provide greater stimulus this year than the two previous ones.

The driving forces behind this development are the financial consolidation in the private sector and several years of highly expansionary fiscal policy. In the past year the fall in interest rates has also generated a substantial stimulus. The fall in net interest expenditure between 1992 and 1994 is estimated at about 2 per cent of household disposable income. Moreover, the household sector has posted substantial one-off capital gains on securities. The fall in rates has also stimulated growth in interest-rate sensitive components of demand, and consequently bank lending is picking up.

A sound basis for sustained growth in the Norwegian economy has been laid in several areas:

- Recent years' extensive financial consolidation in the household sector is apparently coming to an end. If the saving ratio remains at the present level, households will soon be in a considerably better financial position than at the start of the 1980s.

- Domestic price inflation has fallen to a low level and competitiveness has improved. The economy still faces a cost problem, but to a lesser extent than in recent years.

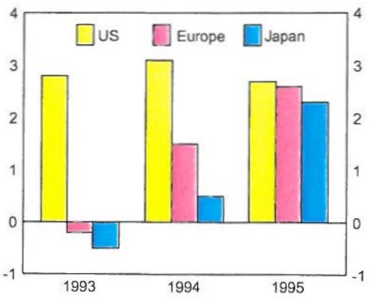
- Unlike many other countries, Norway is running a current account surplus which affords a good basis for further progress. The problem is that the surplus stems primarily from sluggish investment in the Mainland economy and increased oil production.

- Although the budget deficit is a serious problem, general government finances are in a far better state than in most countries.

- Market confidence in the Norwegian economy has gradually improved in recent years. Together with the fall in international interest rates, this has contributed to the drop in domestic interest rates.

- The fall in interest rates has helped to improve banks' earnings and buttress their financial position. While these are essentially one-off effects, the fall in interest rates has also eased borrowers' debt servicing burden and raised the value of banks' collateral. Banks are therefore in a better position to fulfil their role in the economic recovery, and, given their previous experience, we should be able to avoid a debt-financed upturn.

Chart 1
GDP growth in the US, Europe and Japan



The recovery in the US has now lasted since the end of 1992. The economy is projected to expand by 2½–3 per cent in 1994 and 1995. While European OECD countries and Japan registered a weak performance in 1993, growth is projected to pick up gradually, reaching US levels in 1995.

Source: OECD

Although the Norwegian economy displays many positive features, important preconditions for sustained growth are yet to be met: the non-oil exposed sector is still too small, and manufacturing investment remains low. If we fail to reverse this trend and stimulate expansion in sectors already exposed to competition, as well as sectors likely to become increasingly exposed, sustainable growth cannot be achieved, nor can we solve the employment problem. This will be a major economic policy challenge in the years ahead.

Greater stimulus from abroad?

Although the growth we are now witnessing is primarily due to domestic consolidation measures, the trend in the global economy will be crucial for further development.

Here too the outlook has improved, although it will be some time before our export markets show satisfactory growth. While the US and the UK appear to be firmly on the road to recovery, the rest of western Europe is lagging behind to some extent, although the downturn seems to have bottomed out. In western Europe tight monetary policy and high interest rates depressed economic activity for some time, but the decline in short-term interest rates that we have already witnessed, and which is expected to continue this year, will in time engender a recovery. There are also signs of a turnaround in the economies of our Nordic neighbours.

All in all the stage is set for a general recovery across the industrialised world. Growth rates in Japan and Europe are expected gradually to approach US levels. And, although growth among our trading partners is expected to be slightly lower than in the OECD as a whole, their performance will nonetheless be much improved on last year when GDP contracted by ½ per cent.

However, the recovery among industrialised countries may prove weaker than is usual in this phase of the business cycle, which could mean the absence of any significant drop in unemployment in Europe in forthcoming years. The background to this is a pressing need in very many countries to reduce budget deficits, and several countries have already taken action, or made plans, to this end. Even though the fiscal tightening measures will clearly inhibit the incipient recovery, continuing an expansionary fiscal policy would clearly be inappropriate in view of the high level of budget deficits and government indebtedness.

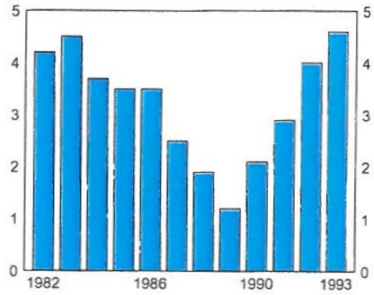
By last year the OECD-wide general government deficit had widened to roughly the level of ten years earlier, and a larger share of expenditure is now tied up in interest payments. General government debt rose rapidly throughout this ten-year period. Both the increase in indebtedness and interest payment obligations have left these countries on a far poorer footing. During the recession, with falling private investment and increased private saving, the growing deficits did not prevent a fall in real interest rates, and European rates may fall further. The projected upturn is expected to be accompanied by increased private investment and consumption on the one hand, and reduced saving on the other. In such a situation it is important to exploit the recovery to rein in government deficits and boost public saving. If such action is not taken, competition for scarce savings and fear of serious central government debt problems may translate into a renewed increase in real interest rates in a few years' time.

In the past year international economic cooperation has taken a further step forward with the successful conclusion of the GATT round and the coming into force of the EEA Agreement. These agreements, which now also cover trade in services, represent a continuation of the trend throughout the post-war period towards increased and freer international trade and keener competition which have spurred growth and enhanced prosperity. Small countries like Norway in particular benefit from the existence of an international legal framework for economic relations.

Extensive international cooperation enables countries to collaborate to attain objectives that would have been beyond their reach individually. The integration of economies in the OECD area, especially in Europe, has furnished a number of examples showing that there are limits to what a country can achieve by unilaterally reorienting its economic policy, but also showing that action taken in one country may have major repercussions for others.

Strengthened international economic policy cooperation is in the best interest of all countries. EU member states have drawn up a white paper

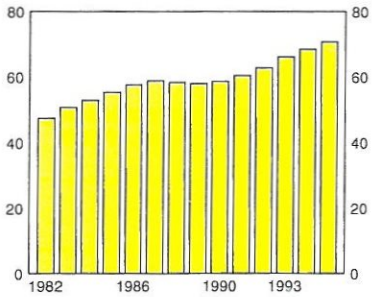
Chart 2a
Budget deficits in the OECD area
In per cent of GDP



In 1993 the OECD-wide general government deficit measured 4¼ per cent of GDP, i.e. about the same as ten years previously. At the end of the eighties budget deficits narrowed appreciably, but by 1993 had climbed back to the previous high levels. As a result central government debt rose sharply - from just under 50 per cent of GDP in 1982 to 66 per cent in 1993.

Source: OECD

Chart 2b
General government gross debt in the OECD area. In per cent of GDP



spelling out measures to reduce unemployment. Following a Norwegian initiative, EFTA countries have drawn up their own white paper, so that now the entire EEA is covered. Its proposals are hardly revolutionary, but the basic idea is important - that in certain areas more can achieved in concert than alone.

A recovery without price and cost pressures

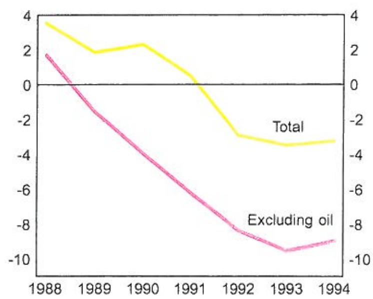
On the domestic front the main challenge is to ensure that the upturn does not trigger price and cost pressures. Given our heavy dependence on the international economy and our ties to the international community, we can never completely control all conditions that are critical to the Norwegian economy. This makes it all the more important to influence conditions that we can control.

An expansion that triggers price and cost pressures cannot be sustained. Moreover, much of the ground we have gained so far, also in the monetary field, would be lost. We know from experience that restoring lost confidence in the Norwegian krone is a very lengthy process. Failing credibility has a price; the price is a higher interest rate than would otherwise have been the case.

The current upturn will eventually lead to some gradual reduction in unemployment. The question will then be whether we can sustain a low rate of price and wage inflation, or whether our effort to do so will be undermined by the forces that determine wage formation.

Unemployment is currently far higher than it was when there were marked cost pressures in the labour market, and also well above the rate that econometric studies indicate will rekindle inflationary pressures. However, we have never in the post-war period experienced a situation where unemployment declines from such a high level, nor do we know whether the skills of the unemployed will match the requirements of new jobs. Countries with far higher unemployment than Norway have seen falling unemployment rapidly followed by cost pressures in parts of the labour market.

Chart 3
Central government net lending
Book value. In per cent of GDP



In 1988, the year before fiscal policy was reoriented in an expansionary direction, total central government financial balances showed a surplus of some 3½ per cent of GDP. In the five years to 1993 the budget balance deteriorated by almost 7 per cent of GDP. The 1994 government budget represents a first step towards a tighter fiscal policy. But a substantial deficit remains, even including the oil revenues. The central government financial position equals this sector's net lending. In contrast to the ordinary calculations of the budget position, investments in state enterprises, primarily in the oil sector, are regarded as saving. The bottom curve in the chart shows net lending excluding central government oil revenues.

Source: Ministry of Finance

In order to secure a sound basis for the level of domestic demand required to stimulate employment and reduce unemployment, our oil-dependence must be reduced. To this end, industries exposed - and those set to become more exposed - to international competition need to strengthen their position. A concerted effort by many parties will be needed to achieve this aim, which should also be a guidepost for the wage round this spring and subsequent ones. The general wage increase is not the only salient factor in this context. Excessive wage increases to individual groups could precipitate leapfrogging to restore wage differentials, thereby gradually pushing up the general cost level.

Improved central government finances

As a result of high oil revenues in the first half of the 1980s, the Norwegian central government was in a strong net financial position compared with other countries. The freedom of manoeuvre this entailed has now largely been exhausted. In the space of five years the government's net lending has deteriorated by an amount corresponding to almost 7 per cent of GDP. Few countries have registered a comparable trend, and those that have experienced a similar deterioration are faced with serious problems with government finances. Norway has avoided such problems because it started out from a positive budget position.

In a recession, expenditure on unemployment benefits rises, tax receipts drop as does spending on taxable goods and services. The resultant fiscal deterioration will to a large extent be automatically recouped when growth resumes an upward trend. However, the government budget projections presented in the National Budget last autumn indicate that the deficit will not disappear of its own accord when growth picks up.

This necessitates a tightening of fiscal policy. The 1994 government budget represents a first step in this direction, and in fact entails a slight reduction of demand in the Norwegian economy this year. But there is a substantial deficit on the government budget, even with oil revenues included. This should be eliminated as rapidly as the recovery and other relevant considerations permit. In a situation of long-term balance, we should instead have a fiscal surplus to meet the social security system's future obligations and to cope with the uncertainty attached to oil earnings.

An economic upturn provides the opportunity to recoup deficits that have accumulated during recession. This can now be achieved without stifling growth. But it will not be easy, for one thing because the increased interest costs generated by the budget deficit have to be financed. However, these costs will become even higher if action is postponed. And so will the debt.

If we recover our freedom of manoeuvre we can avoid a situation which compels us to combat recession with fiscal tightening that causes fiscal policy to intensify rather than dampen cyclical fluctuations. The risk of basing government finances on high current oil revenues can only be reduced by cutting back the deficit.

The drop in interest rates can take some credit for the upturn we are now witnessing. Continued confidence in the Norwegian economy is essential if our favourable position in this area is to be maintained. Confidence may wane if we flinch from making the requisite adjustments to government finances while conditions are highly propitious. It is by no means obvious that interest rates in Norway should be among the lowest in Europe.

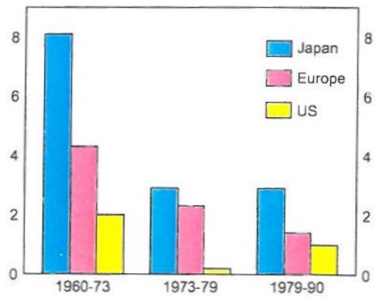
From recovery to sustainable growth?

If we are to be in a position to address the challenges facing the Norwegian economy in coming years, the current cyclical upturn must pave the way for sustainable economic growth in the business sector of Mainland Norway. This is a precondition for reducing oil dependence, securing employment on a durable basis and safeguarding public welfare. Both price inflation and budget deficits have their root in the battle for scarce resources.

Sustainable and stable growth is not achieved automatically; nor can it be taken for granted that countries that are at the economic forefront will remain in this position. There are many examples to the contrary.

In the last twenty years economic growth in European OECD countries has been substantially lower than in the 1960s and beginning of the 1970s. GDP growth has declined by more than half, and productivity gains fell in the 1980s to a third of the level recorded in the 1960s. A trend similar to that in Europe can also be observed in the US and Japan. As Europe and Japan approached the productivity level of the US, productivity growth in Europe and Japan has gradually fallen more in line with US levels.

Chart 4
Productivity
Average GDP growth per employee. In per cent



As Europe and Japan approach the productivity levels of the US, productivity growth in Europe and Japan has gradually fallen more in line with US levels. Productivity growth in the European OECD countries in the 1980s was one third of the level recorded in the 1960s.

Source: OECD

The technological gap between the US and other OECD countries after the Second World War generated a substantial impetus to growth in these OECD countries. A number of historical factors helped to ensure that this growth potential was exploited. A higher level of education and research contributed to the development and diffusion of technological know-how. Transport costs were reduced and tariff rates were cut back. This stimulated competition and provided efficiency gains. High saving pushed down interest rates and boosted investment. The deregulation of capital movements entailed that profitable investments were not hampered by a shortage of capital.

Many of the major factors behind the strong growth in the first few decades after the Second World War are no longer in place. Thus, it is not realistic to expect that the high growth prevailing in this period can once again be achieved. Moreover, growth that causes environmental degradation is not desirable. It is therefore ever more important to orient growth to reduce the impact on natural resources and the environment. It is nevertheless essential to exploit the potential for environmentally sustainable growth that still exists in the international and Norwegian economy. We have not always done this.

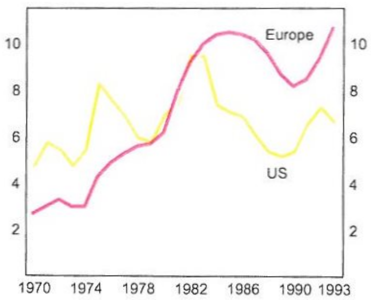
Traditionally, Norway has had a high investment level, but investment has largely been channelled to sectors that yield low returns. Some investments have not been subject to the market test which consists of meeting the required rate of return on capital. Business sector support and distortions in the tax system contributed to tying up labour and capital in certain industries and companies. The conditions which contributed to a poor adjustment capacity proved to be a major obstacle to growth as other positive growth factors lost momentum over time.

We cannot base future growth on oil. There are enough examples showing that many of the richest countries have few natural resources and, conversely, that countries with abundant natural resources have stagnated. The decisive factor for the Norwegian economy is how we succeed in developing the non-oil private and public sector.

Employment in the US and Europe

Since the beginning of the 1970s unemployment in Europe has ratcheted up from one business cycle to another, whereas the jobless rate in the US did not show the same upward trend. Employment growth has been much higher in the US than in Europe. Employment growth in Europe was higher in the 1980s than in the 1960s, but it was not sufficient to stem the rise in unemployment because of the substantial growth in the labour force.

Chart 5
Unemployment
In per cent of the labour force



Since the early 1970s unemployment in Europe has ratcheted up from one business cycle to another, whereas the jobless rate in the US has not shown the same upward trend.

Another striking difference between developments in the US and European countries is the distribution of employment growth between the public sector and the business sector. In Europe there was little employment growth in the business sector during this period, while in the US the private sector accounted for most of the growth. More than half of the employment growth in Europe took place in the public sector. Some of the difference between the US and Europe is ascribable to a higher share of the health sector being included in the private sector in the US, but this does not change the overall picture.

One of the factors behind the particularly high employment growth in the US is the high degree of wage flexibility, which has made it possible to absorb the sizeable inflow of unskilled labour in the US labour market.

Sizeable wage differentials and serious social problems are the other side of the coin. The average wage level has also increased far more slowly than in Europe.

Growth *and* employment

European countries have entered a vicious cycle with sluggish employment growth in the business sector, high unemployment and sizeable budget deficits that lay claim to a substantial share of private sector saving. This has reduced the scope for stimulatory fiscal measures and has resulted in unnecessarily high interest rates and low investment.

A precondition for more balanced economic expansion is higher growth in the business sector. Interest rates must be kept at a low level in order to stimulate investment. Budget deficits must therefore be corrected so that their claim on private saving is reduced. This has become ever more important because the forces which for many years contributed to high growth are now weaker.

Balanced growth will also require an increase in private saving and investment in the most profitable undertakings. In this area Norway has made considerable progress thanks to tax reforms and the development of more efficient capital and energy markets. Greater emphasis has gradually been placed on public sector efficiency and the composition of public expenditure. Transfers have been reduced, providing room for higher investment in infrastructure and education. These measures are consistent with the experience summarised in the OECD and are also embodied in the EU/EFTA employment initiative.

The disparate developments between various countries show that economic growth alone does not automatically secure satisfactory employment growth. A high level of general education and competence is also needed to cope with adjustments, and wages must adapt to productivity developments in society and the growth in the labour force.

Alternatives in wage formation

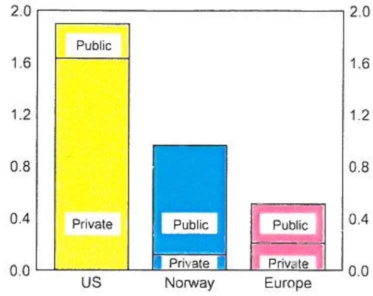
In every economy there are differences in the capacity to pay both between enterprises and between the enterprises which exist and those which may emerge. One salient feature of the US labour market is that wage dispersion is adapted to differences in the capacity to remunerate labour to a greater extent than in Europe and that jobs are created which are not found in Europe to the same extent.

However, this approach to solving the unemployment problem probably seems strange and undesirable to most of us. If Europe and, for that matter Norway, do not wish to take this path, even greater demands will have to be made on other areas to reduce unemployment.

If unemployment is to be reduced while maintaining low wage dispersion, the average wage level must even more so be adapted to the capacity to pay for those jobs that have not yet been created. Implementing such a policy of solidarity raises questions as to attitudes, rules and organisation.

This policy of solidarity can only be implemented if corporate profits are higher so that more investments can be made to create new jobs, and this is contingent on a continued improvement in competitiveness. It is essen-

Chart 6
Employment in the US and Europe
Average annual growth 1960–1990



The US has shown markedly stronger employment growth than Europe over the past 30 years. Growth has also been higher than in Norway. In the US the private sector has made the largest contribution to the growth in employment, while the public sector's contribution has been small. Employment growth in Europe has largely been based on growth in the public sector. Some of the difference between the US and Europe is ascribable to a higher share of the health sector being included in the private sector in the US, but this does not change the overall picture.

Source: OECD and Norges Bank

tial to keep labour costs under control in the major part of private and public sector activities that are less exposed to competition. This may contribute to higher employment and investment and in these sectors and lower costs for inputs and services in industries exposed to competition. Other costs and prices are also important, and the Norwegian Competition Authority will play a significant role in this context.

Such a policy is in line with the EU's growth initiative and will result in higher earnings in all companies, including those where they are already high. If this translates into higher wages for those already employed, no progress will have been made. Extensive coordination on the part of the social partners will be required. Demands must also be made on the allocation of surpluses if this approach is to succeed. It must be based on the returns they can provide in a well-functioning capital market with tax rules that do not lock in surpluses in the activity in which they are created.

The benefit of such a policy will be higher income growth over time. It will result in lower unemployment and reduced budget deficits, which would otherwise have to be financed through higher taxes or a deterioration in public services.

Continued reforms

Studies carried out by the OECD indicate that about 10 per cent of existing jobs disappear every year. Employment growth can only be achieved if the number of new jobs created exceeds this level. The studies also show that net job creation primarily stems from the establishment of new small firms. Facilitating business start-ups may therefore make a greater contribution than was previously thought. This is also probably one of the reasons for the divergent employment trends in the US and Europe.

Other areas should also be assessed in terms of how the markets can be organised to bolster growth in the Norwegian economy. We have been through a reform process in some areas, and this process should continue. Moreover, we must continuously evaluate whether the reforms actually produce the intended results. This applies, for example, to labour market policy and education policy, which affect the level of skills among workers and their capacity to adjust both in the short and long term. And it applies to industrial policy and the instruments of the Norwegian Industrial and Regional Development Fund which help to establish the framework for start-ups and the use of capital.

The functions of the central bank

Economic growth requires a high level of saving, moderate price and wage inflation and the channelling of labour and capital to those activities which yield the highest returns. A fiscal policy that is too expansionary will result in serious problems for government finances, and an overly expansionary fiscal and monetary policy will trigger price and cost pressures. In the longer term both will depress economic growth rather than stimulate it. The contribution that a successful monetary policy can make is to stabilise the economy around its secular growth trend by keeping inflation under control.

As the financial system grows in complexity, the central bank's role extends beyond the conduct of monetary policy and the issue of notes and coin. Efficient financial markets are important to ensure that credit is channelled to investment projects with the highest returns. Deposits can only be safeguarded if financial institutions have sound risk management routines. And, in the absence of an efficient payment system, both wage-earners and businesses will be burdened by unnecessary costs. In all these areas the central bank has a key supervisory and advisory role to play. A well-functioning financial system is an important part of the foundations for economic growth.

The situation in the banking sector and other financial institutions is now returning to normal. The government rescue measures implemented to stabilise the financial markets and the handling of the crisis banks have made an important contribution to this end.

The banks are now run more efficiently than previously. In the last five years the number of man-years has been reduced by more than 20 per cent, and many branches have been closed. But there is still room for efficiency enhancement and further cost-cutting in the banking sector. Excluding capital gains and the temporary effects of government support schemes that have now been eliminated, earnings for commercial banks as a group were far from satisfactory in 1993. Savings bank profits were by and large satisfactory although keener competition with greater pressure on their profits can be expected in the years ahead.

The banks must be efficient, highly capitalised and have sound routines for risk management in order to fulfil their role. Improvements have been made in all these areas. The capital base has been strengthened by the high level of earnings in 1993 and the ongoing issuance of equity capital by commercial banks and savings bank. It is my view that the minimum core capital requirement set out in the capital adequacy requirement is only a first step. If Norwegian banks are to be competitive on the international market, they must achieve a core capital ratio even higher than this.

It is therefore appropriate to place greater emphasis on new issues in this phase than on the disposal of state-owned bank shares. This will promote a more stable financial system and make room for equity capital to flow to other sectors that we want to see expand.

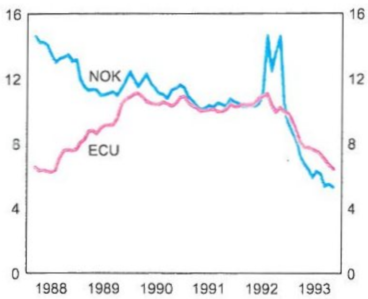
A floating exchange rate

When the Norwegian krone was floated a little more than a year ago, many hoped that a rapid return to a fixed exchange rate regime would be possible. Developments in the last year have altered this perception. It has gradually transpired that the Norwegian krone was no exception, but rather the rule for what other European currencies also experienced. With the widening of ERM fluctuation bands virtually all European currencies are floating in practice. An imminent return to a new fixed exchange rate system in Europe does not seem likely.

This means that Norway must be prepared to live with a floating exchange rate regime for a much longer period than envisaged a year ago, and probably for a long time to come.

Since 10 December 1992 the krone has been very stable, and interest rates in Norway are now among the lowest in Europe. Both short-term money market rates and long-term rates were well below the European average in the second half of 1993, and also below German rates. Compared with the situation prevailing one and a half years ago, money market rates have dropped by 5 percentage points, while long-term rates have declined by 4½

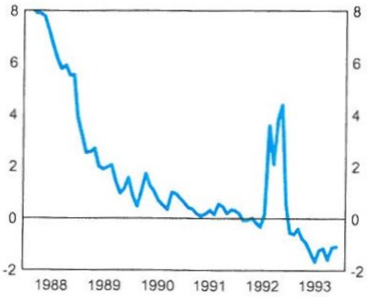
Chart 7
Short-term interest rates, NOK and ECU. Three-month nominal rates



Norwegian money market rates are currently about 5 percentage points lower than in the summer of 1992. The decline is largely related to the fall in international interest rates, but at the same time confidence in the Norwegian krone has entailed that interest rates in Norway have generally fallen more than in many European countries.

Source: Norges Bank

Chart 8
Interest rate differential, NOK-ECU
Three-month nominal rates



In 1988 Norway's interest rate level was 8 percentage points higher than the level in the rest of Europe. Today the difference is 1¼ percentage point in Norway's favour. The narrowing of the differential between the krone rate and European rates mainly took place before the currency turbulence in the autumn of 1992. In the past year the most significant factor for the fall in Norwegian rates has been the decline in international interest rates.

Source: Norges Bank

percentage points. Few European countries have experienced such a steep fall in interest rates as Norway.

In some quarters this is attributed to the floating of the krone. However, the narrowing of the differential between the krone rate and international rates mainly took place before the currency turbulence in 1992. Our relative position has also improved over the last year, but the most significant factor in this period was the fall in international interest rates. The main driving force behind the improvement in our position in recent years has been a stronger Norwegian economy and enhanced credibility.

The experience with 14 months of a floating rate regime has generally been positive. But in this period the conduct of monetary policy was so easy that the former governor of Norges Bank expressed his fear of becoming popular. He found this to be quite unnatural, and we should also refrain from drawing any far-reaching conclusions from this experience.

Although the climate has been favourable in the past year, we must brace ourselves for Norwegian monetary and exchange rate policy again being faced with turbulence and stormy weather. The fundament provided by the establishment of a nominal anchor and clear guidelines will be crucial for our ability to weather such stormy periods.

Under the fixed exchange rate regime the objective of monetary policy was clearly defined: The central bank was to keep interest rates as low as possible without risking pressure against the krone. The situation was somewhat different when we were forced to float. The Revised National Budget for 1993 laid down the guidelines which now apply. The guidelines state that "the aim of monetary policy will be to achieve stable conditions on the Norwegian foreign exchange market."

Now that we must be prepared to live with a floating rate regime for a long period, there may be a need to reassess this guideline.

In its submission to the Ministry of Finance in October on the economic policy programme, Norges Bank indicated that it will make recommendations on this matter to the Government prior to the presentation of the Revised National Budget in May 1994. In this connection we will evaluate international experience with conducting monetary policy under a floating exchange rate regime. Such a review should entail that the long-term objective of monetary policy be clearly defined also in a situation with floating exchange rates that can be expected to prevail for a fairly long period of time.

Experience of other countries

There are some main features that come to light when looking at how other countries formulate policy under a floating exchange rate regime. All countries agree on one score, that low price inflation is the paramount, long-term objective of monetary and exchange rate policy. However, the means of achieving this objective are somewhat different. Generally there are two main approaches:

Countries participating in the ERM have chosen to maintain their currencies as stable as possible in relation to the anchor currency, the Deutsche Mark, even after the substantial widening of the fluctuation bands of the ERM. These countries emphasise that a stable relationship to the Deutsche Mark is still necessary to maintain a credible monetary policy. This credibility has paved the way for low long-term rates, which is perceived as being the best contribution monetary policy can make to a renewed cyclical upturn in these countries.

Many countries that do not participate in any form of exchange rate cooperation have chosen to gear policy towards a more direct objective of low domestic price inflation rather than an exchange rate target. This is the case for the three major currencies and is also common in small countries with floating exchange rates.

The two main approaches pursued internationally are somewhat different in terms of the scope they offer to use monetary policy as an instrument of stabilisation policy. Fixed exchange rates provide very little leeway in this connection. There is somewhat greater scope in countries with a more direct inflation objective for monetary policy. However, if the leeway is used, confidence in the long-term objective being attained may be impaired. The US offers an example of a country that uses monetary policy in demand management, and this does not seem to jeopardise its credibility on price stability.

The monetary policy objectives and guidelines which should be established in Norway is a matter we will revert to prior to the presentation of the Revised National Budget in May. The most important element must be to uphold confidence in our determination to maintain the low price inflation achieved.

Low price inflation must be sustained

Our experience with 10 years of frequent devaluations up to 1986 led to the conclusion that this approach was not an effective means of bolstering competitiveness. The consequences were high price inflation and faltering credibility. The price that had to be paid for this came in the form of higher interest rates, and the functioning of the economy was impaired. As price inflation was reduced, the credibility of our fixed exchange rate policy was reinforced. But it took time to defuse inflationary expectations, and a reorientation of economic policy was necessary in order to restore its credibility.

Only then did the fixed exchange rate policy have a disciplinary effect on fiscal policy and wage settlements. It became clear that we could not allow price inflation to exceed that of other countries. Our strict adherence to a fixed exchange rate regime entailed that the level of price inflation in our trading partner countries took on the role of a nominal anchor for Norway. Competitiveness can thus only improve if we achieve a lower level of inflation than that of other countries.

We must continue to maintain the ambition of low inflation also with a floating exchange rate, and we need a nominal anchor. This has also been the underlying aim of monetary and exchange rate policy over the last year. But monetary policy does not alone suffice to attain this objective if fiscal policy and income settlements fail to underpin the direction of economic policy. It is therefore important that the Norwegian Employment Commission's approach be followed up. A main element of this approach is notably that price inflation in Norway must be lower than in competing countries in order to boost competitiveness.

Subduing inflation and crushing inflationary expectations entailed substantial costs and problems. This has now been dealt with. We should avoid having to go through this process once again, which we will have to do if the present policy is abandoned.

Many countries that have established inflation targets have either experienced high price inflation or had already seen their currencies depreciate to the extent that they were faced with a substantial risk of renewed inflationary pressures. They have set inflation targets as a goal they must strive to attain. Our task is now to preserve what we have already achieved.

The role of the central bank with a floating exchange rate

Norges Bank's role was clearly defined in the period with a fixed exchange rate regime. The objective of monetary policy was to maintain the fixed exchange rate and the central bank's task was to ensure this. Under a floating rate regime, the objectives of monetary policy and the role of the central bank are less clear.

So far the disciplinary effect of the fixed exchange rate has been carried over to the floating rate regime, and price inflation has been kept at a low level. The aim of monetary policy should be to sustain this. If this approach receives political support, the central bank's role will essentially remain the same as under the fixed exchange rate regime.

However, a floating exchange rate regime may make it easier to succumb to the temptation of departing from the agreed approach. Therefore it would be an advantage to establish a clear division of responsibility regarding the operation of monetary policy and lay down explicit guidelines for monetary policy under such a regime. However, it is of crucial importance that these guidelines receive the political support necessary to implement them.

Such acceptance and explicit guidelines will be beneficial to the economy because in adverse situations participants in money and currency markets are made fully aware, both through words and action, of the primary objective of monetary policy. Over time this will secure lower interest rates and more stable economic developments in Norway than will otherwise be the case. This is the best contribution that monetary policy can provide to promote sustainable growth in the economy.

In the absence of a clearly defined monetary policy objective, the role of the central bank will be less clear. Both in Norway and internationally, experience shows that there are costs associated with the failure to establish a distinct division of operational responsibility between the political authorities and the central bank. We all know what the consequences will be if others lose confidence in our ability and will to maintain a firm stance.