Money and the importance of confidence

Speech by Governor Øystein Olsen at the Museum of Cultural History 3 June 2014.

Thank you for the invitation to speak about an important topic for a central bank – the importance of confidence in the value of money. I would also like to commend the Museum of Cultural History on an exciting and thought-provoking exhibition.

Some of you may have seen the Norges Bank exhibition and read the dramatic account of the evacuation of Norway's gold bullion in 1940. At the time, gold was the country's most important international reserve and it was imperative to remove the gold from German-occupied Norway. The government-in-exile in London could easily exchange the gold for hard currency, which gave it room for manoeuvre.

Metal as a means of exchange has a long history, as far back as ancient Mesopotamia 5,000 years ago. There for the first time, people began using small pieces of metal with the weight stamped on them as a means of exchange. Mesopotamia was – for its time – an advanced society. Agriculture was extensive, and in the towns people specialised in various occupations. Trade in goods and services necessitated a generally accepted means of exchange. These pieces of metal were useful in making trade in goods and services efficient.

From Mesopotamia, we must make a substantial leap forward in time – 2,600 years – to Lydia on the west coast of present-day Turkey. Here, for the first time, we find identically formed pieces of metal, with the king's stamp to guarantee its weight. This is considered to be the first form of money.

Today, money takes many forms. While we continue to carry coins around with us, we also carry banknotes and have access to deposit money. Using bank cards and mobile phones, we can quickly move money from one account to another, transactions that are only visible as digits on a screen. Even so, we have confidence in the money these digits represent.

Money fulfils three essential functions. It functions as a generally accepted means of payment. It is useful as a measure of value and unit of account and it is well-suited as a store of value. A well-functioning monetary system is fundamental to an economy. It gives us the freedom to manage the wealth we create.

The ability to sell our labour or the goods we have produced for money makes commerce and specialisation possible. Long-term contracts to buy and sell can be entered into when we can be sure that money will retain its value. In addition, money is impersonal. We are no longer bound to bartering. We are free to decide where and how our money will be spent.

When the value of money is stable, we are also free to choose when to spend it. Income earned can be saved as a buffer against unforeseen events or can be invested in property or production equipment. High inflation results in an arbitrary redistribution of wealth from savers to debtors, destroying incentives to save. Deflation or a fall in prices is also problematic. It increases debt burdens, a phenomenon we witnessed in connection with the

par policy in the 1920s and the depression in the 1930s. Both high inflation and deflation adversely impact investment in productive capital.

In periods of high and variable inflation, information inherent in the price of a good is concealed. It becomes unclear whether a change in price is due to an increase in the general price level or whether the costs of producing the good have risen. Misallocation of investment may result. High inflation can also be self-reinforcing. Once inflation has taken root, the public becomes accustomed to quickly rising prices, taking this into account in both wage settlements and when setting prices. This became a serious problem in the 1970s and 1980s.

If money is to fulfil its function, the public must have confidence that it will retain its value over time. The history of the monetary system is an account of how the authorities at various times have tried to build confidence in the value of money. But it is also an account of how in many cases that confidence was undermined.

Coins initially came to Norway as foreign currency – a result of the Vikings' extensive trading activities. After King Harald Hardraade established the first Norwegian mint, Norwegian coins quickly supplanted foreign coinage. The coins bore the royal stamp as a guarantee of their silver content. When a new king assumed the throne, the old coins were collected and exchanged for coins with the new royal stamp. Coinage thus served as a means of reaffirming the power of the reigning monarch.

There are numerous examples of medieval kings' gradual debasement of silver coins. By reducing coins' silver content or offering a lower redemption price when old coins had to be exchanged, the crown was able earn a profit. Kings restricted the use of other coins by law. The Norwegian monarchs were not the only ones who undermined confidence in coinage by reducing their silver content. The most notorious example is Henry VIII, who turned coinage debasement into a rather ignoble art.

In the course of the 1700s, many countries introduced banknotes as legal tender. The notes were a kind of security that entitled the bearer on demand to a certain quantity of silver from the issuer. The right to issue notes was granted by royal charter.

While the use of paper money was efficient, it also made it easy to dilute the value of money. Whereas minting silver and gold coins was limited by the amount of available precious metals, it was inexpensive to print paper money. There was little to prevent an absolute monarch from cranking up the printing press if temptation or the need for money became too acute. Europe was far from being a peaceful continent. Wars were constantly breaking out, and they needed to be financed. This often led to the suspension of the obligation to redeem notes in specie.

In Denmark-Norway, the obligation of the bank of issue to redeem notes in silver was abolished in 1757 following the outbreak of the Seven Years' War. In the following years, recurring wars and conflicts were financed by printing new notes. Attempts to restore order to the monetary system were half-hearted and often made matters worse.

The Napoleonic Wars brought chaos to the monetary system. When Denmark-Norway was pulled into hostilities, there were two banks – both with royal charters – that issued banknotes: *Riksdaler courant* and *riksdaler* specie notes circulated side by side. King Fredrik VI continued to finance public expenditure by printing money. The naval blockade of Norway made it difficult to obtain supplies of banknotes from Denmark. To remedy the money shortage, the government commission issued money substitutes in the form of bearer certificates redeemable in *riksdaler* notes called *assignasjonsbevis* that could be used to pay public debt. In addition, Norway was plagued by a series of crop failures.

The combination of commodity shortages and increased notes in circulation led to hyperinflation and a lack of confidence in the monetary system. From 1806 to 1813 the price level rose more than twenty-fold. In 1813, paper money was devalued by nearly 90 percent, while a new bank of issue was founded and a new monetary unit established the *riksbankdaler*. But the chaos in the monetary system and the public's lack of confidence in the value of the notes persisted. Accounts between the merchant Poul Hansen in Tromsø and the innkeeper Thom'søn on Burøy island were kept in commodities such as cod liver oil or pollock. The monetary system was on the verge of collapsing.

The separation from Denmark split the Danish-Norwegian monetary union. At Eidsvoll, Christian Magnus Falsen, a key member of the Constituent Assembly, stated that no state can exist without a well-functioning monetary system. A currency of its own would be a symbol of Norway's sovereignty and independence.

The people's elected representatives took responsibility for the monetary system, as stated in Article 75 of the Constitution: *"It devolves upon the Storting to supervise the monetary affairs of the Realm".* Under the November Constitution, Norway was to have its own bank and its own monetary system.

The king would no longer have the authority to print money at will. Behind this decision were bitter memories of the near collapse of the monetary system during the period of the union with Denmark and inspiration from Enlightenment philosophers and the American and French revolutions. Absolute monarchy under the Danish king was to be replaced by sovereignty of the people and the separation of powers. Institutions with clearly distinguished roles would serve as a check on the arbitrary use of power and foster confidence.

The Storting delegated the task of supervising the monetary system to Norges Bank, which was established in 1816. At its inception, Norges Bank's head office was located in Trondheim, a twelve-day journey from the government in Christiania, and even farther from Stockholm, giving the central bank a geographical – and not just formal – distance from the government authorities.

Getting the economy back on its feet was a matter of urgency. Without confidence in the monetary system and currency, Norway's economic freedom would be limited. However, it would take time to restore confidence in the value of money. During the first years after 1814, there was a large volume of various banknotes in circulation, recurrent devaluations and sharp price rises. Between 1814 and 1817, prices more than doubled.

During the debate on government finances at Eidsvoll on 13 May 1814, the Constituent Assembly had decided to print a sufficient quantity of riksbankdaler to cover the fiscal deficit. The members of the Constituent Assembly personally guaranteed both government debt and the price of the banknotes. This was referred to as the "Eidsvoll guarantee". However, this guarantee was not followed up by specific action. Moreover, the economic foundation for a stable value of money was not yet in place. The guarantee was rejected by the Storting already after two years, and the riksbankdaler was replaced by the speciedaler. The value of the money was to be guaranteed by a stock of silver. A silver tax was levied.

For a young nation it was costly to break the promise of a stable value of money. The revocation of the Eidsvoll guarantee was noted in other countries. When the government needed to borrow, it was difficult to find lenders. Loans that eventually were granted had strict terms.

The introduction of the speciedaler did not restore needed confidence in the monetary system. In addition, it proved difficult to collect the silver tax. The value of the speciedaler fell. In 1822, the Storting decided to adopt a more long-term strategy. The conversion rate was to increase gradually to its par silver value. At the same time, a strict economic policy was pursued that brought the government's finances back into balance, and government debt was paid off. Not until twenty years later – in 1842 – was confidence established and it became possible to redeem paper money at its par silver value.

The second half of the 1800s was a period of solid economic growth and stable prices. During this period, countries increasingly began to peg their currencies to gold, and an international system of fixed exchange rates under a gold standard emerged. Norway adopted the gold standard in 1874, at the same time as it entered into a mint union with Denmark and Sweden. The krone replaced the speciedaler.

World War I brought a quick end to the stable monetary system that had been in place during the preceding decades. In a number of countries, the authorities again yielded to the temptation to finance the war through the printing press. High inflation became a problem once more.

Norway did not take part in hostilities. But its monetary and fiscal policy still spiralled out of control. Members of the public stood in long queues outside Norges Bank's branches to exchange banknotes for gold. A law was quickly passed that temporarily suspended Norges Bank's obligation to redeem banknotes for gold. For a neutral nation like Norway, the world war gave rise to considerable export revenues. The speculative economy that followed resulted in strong credit growth, and sharp asset and consumer price inflation. The money supply increased substantially. The value of the krone against gold declined sharply both during and after World War I. By 1920, the purchasing power of the krone had been reduced to a third of what it had been before 1914.

After the war, Norway would again experience the cost of rebuilding. Nicolai Rygg, who became Governor of Norges Bank in 1920, quickly set to work on the task of returning the gold value of the krone to its pre-war level through what was known as *par policy*. A restrictive credit policy was pursued. Inflation fell sharply and real interest rates rose. Despite a banking crisis and economic turbulence, pegging the krone to gold at par was

achieved in May 1928. But the costs were considerable. A strict monetary policy and a krone exchange rate that was overvalued against other currencies resulted in bankruptcies and unemployment. Through most of the 1920s, prices fell. Par policy was strong medicine for a weak economy.

The effects of par policy were painful and were criticised from numerous quarters. Rygg paid little heed to the criticism. He insisted that a weaker krone exchange rate would be a betrayal against savers, while weakening confidence in monetary management in the longer term. Rygg was very much aware of the problems associated with restoring confidence a hundred years before. He had even written a book about it. In retrospect, it would be fair to say that monetary policy was unduly inflexible and that Rygg should have taken greater account of economic activity and employment. But the experience of par policy also offers another lesson. There are substantial costs associated with reducing inflation once the anchor has slipped.

In Europe and the US, the interwar years were characterised by an economic downturn, with deflation and unemployment. Tariff barriers and exchange rate instability put a brake on international trade. During the final phase of World War II, the US and a number of European countries came together to create a stable framework for economic recovery in the post-war period. The economic chaos of the interwar period was to be averted and replaced by stability and fixed exchange rates.

The Bretton Woods system laid the groundwork for a broad-based foreign exchange regime in which currencies were pegged to one another. The US dollar was to be the anchor of the system, with a fixed value in gold. The value of other currencies, such as the Norwegian krone, would thereby be kept pegged to the dollar. The indirect link to gold was to serve as an anchor for stable money.

During the first 25 years after World War II, the Bretton Woods system contributed to low inflation and international monetary stability and provided a solid foundation for the post-war recovery. However, the system came under pressure. One reason was that the dollar could not be devalued. Towards the end of the Vietnam War, it became difficult for the US to maintain a fixed exchange rate, and the Bretton Woods system collapsed in 1971. That was the last time currencies were linked to gold.

The following period was characterised by high and accelerating inflation. The krone was linked to various fixed exchange rate regimes, none of which were particularly long lived. Economic policy, not least in Norway, was based on the belief that the economy could be fine-tuned. There was a widespread view among economists and policymakers that low unemployment could be achieved at the price of higher inflation. Central bank independence was limited. Policy rates were primarily to be used to support investment and employment. The authorities had a declared objective for the value of the krone. But they devalued quickly when high wage and price pressures in Norway relative to other countries became a challenge for export industries.

The importance of price stability was lost from view. The nominal anchor slipped. The relationship between inflation and unemployment did not prove to be especially robust.

The inflationary period of the 1970s and 1980s cannot be linked to war or crop failures. This time, the cause lay in the system for managing the economy. Packages of measures, wage and price freezes and devaluations gradually proved to be the wrong medicine.

A needed course correction came in the wake of the fall in oil prices in 1986. The authorities did everything in their power to gain control over the budget deficit that had built up. In spring 1986, Norway devalued for the last time, and the authorities abandoned the use of politically administered interest rates. Interest rates would be set with a view to maintaining a fixed krone exchange rate. Inflation would thus be brought down towards the level prevailing in other countries. Following widespread speculation in a number of currency markets in 1992, the krone was allowed to float. Monetary policy would continue to aim for a stable krone, but within a wider band than before.

During these years, painful remedies were applied to the Norwegian economy. But gradually, confidence in monetary policy regained a foothold, and inflation and real interest rates declined.

Towards the end of the millennium, it became increasingly clear that the system of fixed exchange rates had outlived its usefulness. Oil revenues rose, and the social partners again had problems with managing cost growth. With the free cross-border movement of capital, there was a tendency for the fixed exchange rate policy to amplify fluctuations in the economy. A new anchor was needed.

In 2001, an inflation target was defined for monetary policy. Norges Bank was tasked with setting the key policy rate with a view to keeping inflation low and stable. At the same time, the fiscal rule was introduced as a guide for spending oil revenues.

Together, the inflation target and the fiscal rule have resulted in a stable regulatory regime, based on important lessons. The primary objective of monetary policy must be price stability. But without responsible public spending, this task may become too onerous.

Interest rate setting has been anchored by an inflation target since 2001. Inflation is currently so low that most members of the public scarcely give it a thought. Consumer price inflation has disappeared from the front page of newspapers, where it was a frequent guest in the 1980s. When members of the public feel confidence in the value of money, they can enter into long-term contracts with this in view. Expectations of low inflation are in themselves an important contributor to keeping inflation low.

And this brings me back to my starting point this evening. If money is to fulfil its function, the public must have confidence that it will retain its value. The primary objective of monetary policy is to safeguard the value of money, expressed as low and stable inflation. The instrument for achieving this objective is the key policy rate. But as the key policy rate also affects other economic variables, the inflation targeting regime is flexible.

In Norges Bank's conduct of monetary policy, the objective of low and stable inflation is weighed against the objective of stability in output and employment. Monetary policy also aims to be robust, including taking account of the uncertainty surrounding economic driving

forces and the functioning of the economy. Monetary policy also seeks to mitigate the risk of a build-up of financial imbalances.

Confidence in the inflation target provides the freedom to take other factors into account when setting the key policy rate. If confidence in the value of money should break down, we would lose that freedom. And as history has taught us, restoring confidence can involve considerable costs and may take a long time.

The financial crisis was a reminder that low and stable inflation is not sufficient to prevent financial crises. Regulation of the financial system must be improved. In response, new regulatory instruments for the banking sector are now being introduced in many countries.

While increased capital requirements will strengthen banks' solidity and may mitigate the build-up of imbalances, we cannot proceed under the assumption that new regulations will eliminate the risk of financial instability. A robust monetary policy will therefore continue to take into account the risk of a build-up of financial imbalances.

A central bank's tasks and instruments change over time. Today there are new and exciting challenges to pursue. With macroprudential regulation of the financial system many central banks have been assigned new tasks with regard to ensuring financial stability. It then becomes important to maintain a clear distinction between the objectives of the different instruments. The key policy rate and the buffer are designed to promote different objectives. Monetary policy is geared towards ensuring low and stable inflation and is the first line of defence in managing business cycles. The countercyclical capital buffer is designed to strengthen banks' resilience to large losses. Monetary policy must not be overburdened. When assessing the monetary policy trade-offs, the primary objective of monetary policy must remain low and stable inflation.

Thank you for your attention.