

Losing Credit

The Politics of Liberalisation and Macro-Economic
Regime Change in Norway 1980-92 (99)

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Preface

The idea for this thesis came to me during a telephone conversation. In October 1996 I was at home enjoying father's leave when a journalist called. He knew I had previously written about credit market liberalisation. Now he wanted to check if I had any opinions on the continuing battle to shift blame for policy mistakes made in the 1980s. Mistakes that most people agreed contributed to the Norwegian banking crisis. Who was to blame for the fact that interest rates were kept low after liberalisation? Was it Kåre Willoch who was Prime minister from 1981 to 1986, his coalition partners in the centre or the opposition to the left? Should the Central Bank have opposed this policy, or was it unfair to point an accusing finger towards what was really a "directoriate" with no policy making tradition? Furthermore, why were the deductibility rules of the tax system not modified before the banks started hyper-expanding, and why were the markets for shares and property liberalised before the credit market?

Other questions were not on the journalist's list, but might well have been: How could the Ministry of Finance allow capital adequacy standards to be debased at the same time as risk exposure in banking grew faster than ever? Was the credit market really liberalised through political actions, or did the banks and other institutions set themselves free. And did it really matter one way or the other since policy responses to credit market developments were mostly inadequate anyway? Finally, why was the contraction pursued by way of monetary policy and tax reform so ill-timed that in effect it brought record high post tax real interest rates upon an economy in depression?

I felt weary. Leading personalities of the 1980s had already been hitting each other over the head with many of these questions in several rounds since investigations into the banking crisis began around 1990. Then the thought struck me. Maybe I felt tired of the whole debate because the unspoken premise – that there was a key mistake and some individual should be blamed for it - was unreasonable? Thus I gave my journalist what I believed was a new and interesting line of argument. I suggested to

him that the whole debate was futile, because to oversee a substantial transformation of the framework for economic policymaking is a very difficult job. It was a job that entailed sequencing several reforms, some deeply unpopular, in a sensible manner. The jurisdiction of different institutional actors overlapped without matching each other. In short, a process with many stakeholders, large grey areas and several veto-points and players.

Later that day the journalist got hold of some of the key actors. In the final version of his article my comments were dropped to make room for another round of individual level blame game playing. So instead of press coverage, I got a thesis question. I also landed myself a topic that is difficult to write about. There are at least two particularities that run through this work, compared to the standard design of research where the main tasks are descriptive and explanatory.

Firstly, by taking an interest in what went wrong I have had to establish a conceptual measuring rod with contested normative connotations – what exactly is a policy failure? This is a problem research designs with more neutral values on the dependent variable such as bigger/smaller or more/less does not have to confront. Secondly, framing the issue as one of co-ordination breakdown also has its inherent problems. It is always an advantage to be able to delimit one's research problem. Then one can perhaps produce a tidy analysis of why an event occurred, or why a variable with one or just a few dimensions changed value? The joys of simplicity are not so readily available for those of us who study co-ordination. By definition policy co-ordination presupposes several policies. Hence the study of it forces you to address a series of events embracing different policy areas subject to different dynamics. Furthermore, attempting to account for these different dynamics leads one to pursue many theoretical threads. Threads that ideally should be woven together in a meaningful pattern.

To my efforts to overcome these difficulties in addition to the more standard chores of writing a dissertation, several people have made useful contributions. The greatest contributor has been my supervisor, professor Trond Nordby. I will always be grateful for the way he immediately took me on when I at one point was left drifting

midstream. After calming me down he continued to mix advice, encouragement and the occasional mild scolding when that was called for, all through the process. Øyvind Østerud has also provided valuable support and advice, reading the outline and then the whole manuscript in draft. Kåre Hagen, Sjur Kasa, Lars Mjøset and Johan P. Olsen have read the theory sections critically and all have suggested important improvements.

I have been associated with 3 different research institutions while working on this project. The comradeship and continuing intellectual exchange at ARENA, with colleagues such as Jeff Checkel, Dag Harald Claes, Jon Erik Dølvik, Andreas Føllesdal, Kristin Eikeland Johansen, Inger-Johanne Sand and Bjørn Otto and Ulf Sverdrup always available for a quick discussion or a helping hand has been invaluable. A succession of “sivilarbeidere” beginning with Simen Bræin and now at the last stage Dag Gravem Hansen have provided appreciated assistance throughout.

I am also very grateful to the *Wissenschaftszentrum Berlin für Sozialforschung, Abteilung Wirtschaftswandel und Beschäftigung*, where I spent the academic year 1997-98. The director, David Soskice, and my colleagues there, such as Bob Hancke, Steve Casper, Sigurt Vitols and Ilona Koehler all made me feel welcome, intellectually and socially. In fact the WZB environment was so hospitable and stimulating that what one could call the “Soskice-school” - the varieties of capitalism approach - ended up profoundly impacting my thinking, even though I for long thought I had resisted this.

The Department of Political Science at the University of Oslo has been a terrific employer. It has given me the flexibility to travel and work with the people I chose, it has trusted me with challenging teaching tasks and it has provided a supportive and stimulating intellectual environment of its own. Nils Butenschøen, Helge Hveem, Leif Helland, Raino Malnes and Marit Reitan deserve a special mention because they have all made contributions to the present work. Furthermore, the efficient and pleasant way the institute is administrated has made my job easier. Ingar Refvik Bondhus and Øyvind Sørbye have both helped me in the final stages. This thesis has also benefited from exchanges with students. What I have gained from supervising Øyvind Berre, Birgitte Kjos Fonn, Anne Flæte, Bjørnar Dahl Hotvedt and Petter Hveem (who

also provided capable research assistance) is most easily traced in the text, but I have learned from all my students.

Other colleagues have also taken time to read and discuss various drafts and conference papers of mine or just to discuss key ideas. I owe thanks to Mark Blyth, Peter Hall, Paul 't Hart, Torben Iversen, Eric Helleiner, Andreas Hompland, Sverre Knutsen, Einar Lie, James March, Jonathon Moses, Sofia Perez, Richard Swedberg and Espen Søylen. Most of these people also appear frequently in my reference list. Furthermore, I am indebted to all the interviewees who without exception have been patient with my idiosyncratic lines of questioning. A full list of the interviewees is provided in an appendix, but former Central Bank governor Hermod Skånland deserves special mention. I first interviewed him for my hovedfags-thesis in 1992, and since then I have been back twice in addition to e-mail and telephone contact. He is in a special position since he is a source, an admired but also often criticised key actor, and a commentator at the same time. He has read a full draft of this thesis and other articles of mine. His generous advice has come in the context of long exchanges, and they have forced me to reflect and improve. But his comments have never been intrusive or self-righteous.

Last but most important, I have to thank my family. Anne Grete, Hans Peter and I have had some wonderful times moving around Europe. The combination of thesis writing and a (at times) high-powered diplomatic career is not always easy to reconcile with family life. But we have come through it a stronger unit. To be part of a loving family puts the fundamentally self-possessed activity of writing in its proper perspective. I love you both. Hans Peter's grand parents, Bodil, Eva and Knut Erik have all made significant contributions by hosting us in Norway, and coming down to Berlin and Vienna to provide a stabilising and loving influence when things have been at their most hectic. My father, Knut Erik has also bravely worked on my language, even though he knows from experience that this is a thankless and risky task. Thanks also to Alma and Norman for taking good care of us in our everyday life.

Vienna March 2000, Bent Sofus Tranøy

List of acronyms

BIS	Bank for International Settlements
CB	Central Bank
DnB	Den norske Bank
DnC	Den norske Creditbank
ECB	European Central Bank
ECU	European Currency Unit
EEA	European Economic Area
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	European Exchange Rate Mechanism
EU	European Union
IMF	International Monetary Fund
LO	Landsorganisasjonen i Norge (The Norwegian Confederation of Trade Unions,
MOF	Ministry of Finance
NBA	Norwegian Bankers Association
NHO	Næringslivets Hovedorganisasjon (The Confederation of Norwegian Business and Industry)
NOK	Norske kroner (Norwegian Kroner).
OECD	Organisation for Economic Co-operation and Development

Chapter 1: Introduction

1.1 The argument in brief

In writing this thesis I have had two ambitions. First of all I wanted to ask questions hitherto not raised in the debate on the Norwegian banking crisis of the early 1990s. This is primarily an empirical ambition. At the same time I wished to contribute to an international debate on institutional change. This is a theoretical ambition.

More specifically, the empirical issue is that of explaining why Norwegian economic policy lost its cohesion under the strains of liberalisation and Europeanisation in the 1984 to 1993 period. This is an important task, because it has not been undertaken so far. The effects of policy – the Norwegian boom and bust cycle of the mid-1980s to the early 1990s and the resulting banking crisis – are now well understood. My labelling this a policy fiasco serves to draw many decisions together under one conceptual umbrella, but it adds little of substance. Put differently: most observers can agree that the economic governance of the period failed, but they have not asked why this came to be the case.¹

The theoretical effort also seeks to help filling a void. Preconditions for stability and even for gradual change are well understood in the institutionalist literature on economic policy. As regards large scale and long term institutional change the prevalent mode of reasoning is comparative statics. This way of thinking brings out the difference between different regimes in a clear manner since it directs attention towards consecutive equilibria “punctuated” by performance crises. Relatively less attention, however, has been accorded to processes of regime change. In comparative statics, processes are not interesting in themselves. The key task is to identify the agent of change (broadly defined) and to describe rival equilibria. The notion that processes of change can be drawn out enough, and so rich in medium term unintended

¹ The concepts of policy fiasco’s and policy failure will be elaborated upon in subsection 1.3.1.

consequences to merit study in themselves, is foreign to the comparative statics framework.

This is a case study of such a period of change. Emphasis on its unintended consequences or what we can call the medium term costs of adjustment. In the mid-eighties and early nineties, the policy regime within which Norwegian credit and monetary policy was executed was liberalised and europeanised.² In the old regime functionally interdependent policies were (although not always deliberately) mutually adjusted to each other. This secured a counter-cyclical credit policy backed up by routines in other issue areas (such as interest rate-, fiscal-, tax-, exchange-rate-, prudency- housing- and capital market- policy). The regime had endurance because there was a minimum level of cohesion between decisions reached at different times, within different policy areas and between different government bodies. Liberalisation and Europeanisation entailed moving away from core routines of the regime.

In the period under study here, policies became brutally pro-cyclical: policy exacerbated rather than modified the cyclical swings of the economy. In the boom phase (1984-87) policy fuelled speculative borrowing. Credit supply overshooting hovered around 100 percent per year compared to Government targets. Norway's biggest banks roughly doubled in size in less than three years. Then policy exacerbated the credit crunch of the bust phase (1988-92). Credit supply fell dramatically and turned negative. Real, post-tax interest rates increased by 6-8 percentage points reaching record levels, setting the stage for a depression and a banking crisis. Gross accumulated losses 1987-1992 as they appeared in the bank's books were 70.6 billion NOK. This corresponded to slightly more than 10 percent of GDP in 1991. The three

² *Liberalisation* can be defined as a political process that brings the regulatory framework within which policy is conducted, more in line with the ideal of a "free" market. The number of goals pursued through policy is normally reduced. But if multiple goals are maintained this is attempted done in ways that do not hinder competition in playing itself out on a "level field". It is a market building exercise that demands new interpretations and changed behavioural patterns from both state and economic agents. *Europeanisation* is defined here as impacts from European level governance regimes on national policies, politics, and institutions. For this thesis, two European governance regimes are of central importance. Firstly the internal market, the main impact of which has been a continuation, widening, and cross-national harmonisation of the liberalisation agenda. Secondly, Norwegian policy has been impacted by the European Exchange Rate Mechanism (ERM), a subset of the European Monetary System (EMS) that sought to provide exchange rate stability across Europe.

biggest banks in Norway needed Government support to avoid bankruptcy. Total support for the banking system corresponded to about 3.7 percent of GDP in 1991.³

The sequence of decisions and non-decisions that together amounted to this fiasco was roughly as follows. In the early eighties, the markets for shares and housing were liberalised. Then in 1984 the credit market received a twofold liberalising stimulus. Key credit controls were lifted and restrictions on establishing new branches were more or less abolished. Thus the supply side of the market, and the competitive climate, were boosted. The problem was that this was done without implementing complementary measures attending to other aspects of the regime. Specifically, foreign and then central bank funding was easy to obtain. Together with the relaxation of capital adequacy these were necessary conditions for the banks to expand at break-neck speed. Nominal interest rates were regulated downwards and generous deductibility rules on interest rate payments were left unchanged. Together with a lax fiscal stance this produced a corresponding growth in demand for credit. The newly liberalised asset markets took off, further stimulating the credit boom. In a self reinforcing process this led to a general and strong overheating of the economy.

In late 1986, after three years of unprecedented growth in private consumption, the authorities tried to tighten policies. Pressured by the collapse of the oil price and inspired by the apparent success of the EMS, Norway proceeded to transform her fixed exchange rate policy from a paper tiger to one with teeth and claws. First the “krone” was fixed to its old basket, and then in 1990 to the ECU. Under the prevailing market conditions, this meant that nominal interest rates were forced upwards and remained high. Inflation came down and the tax system was reformed. All this amounted to rapidly increasing real post tax rates as the business cycle fell off, pushing the economy into a free fall of busting banks and businesses, rapidly rising unemployment, depressed property prices, and financially troubled households. Accession to the EEA treaty opened up the currency market. This facilitated massive speculation against NOK. The determined response to which came in the shape of dramatic short term

³ The Ministry of Finance has calculated that the net cost to the state was about 6.6 billion kroner in St.Meld. nr. 39 (1993/94:29).

interest rate hikes and “crisis packages” in Parliament. Recovery was not in sight before ECU linkage was given up and only started to take off after the ERM crumbled and European interest rates came down in the autumn of 1993.

Although there are differences in terms of emphasis, there is a general consensus among Norwegian economic historians and economists that the policies just outlined played an important role in facilitating the financial crisis that unfolded at the turn of the decade. I will review the intimately related debates over causes and blaming in subsection 1.2.2.1 below. I will also return to the discussion of causality versus blameworthiness in the last concluding chapter, in subsection 7.1. At this stage suffice it to say that the present analysis takes it as a premise that there is a general consensus on the causal relevance of policy for the crisis. This premise is necessary to clear the way for going one step backwards in the causal chain and explain policy rather than producing yet another effort gauging its impacts.

That regulatory reform was to contribute to a trajectory that damaged policy cohesion (and thus ultimately business performance, financial stability and the economy as such), is not reducible to the motives of any one actor or sets of actors. I do not deny, however, that this case is littered with instances of powerful individuals displaying poor judgement. With the benefit of hindsight that much is clear. Still, this analysis seeks to move beyond such singular acts. In stead it seeks to uncover some of the cognitive, organisational and political mechanisms that influence decision (and non-decision)-making and therefore, co-ordination. My strategy is to develop a theoretical argument that links regime change and likelihood of fiascos in macroeconomic and regulatory policy in the monetary sphere. The key point is that rapid and substantial change in some of the routinised policies that make up a policy regime can put insuperable pressure on the co-ordination capacity of the polity as a decision making system. This can lead to a situation where different policies are allowed to undermine each other.

Utilising a vocabulary and a way of thinking which draws more on organisation theory than on political economy, we can say that this happens because policies that are tightly coupled in functional terms, are only loosely coupled in the decision making

process. Under the heading of *disparate policy paths*, I distinguish three different categories of sources of co-ordination breakdown. I suggest the term disparate policy paths to underline that I am not primarily interested in separate policy trajectories per se. I am interested in the relationship between them. That is to ask, why was policy change and policy continuity so poorly mixed that it ultimately amounted to a fiasco. These three sources of co-ordination breakdown I call respectively *asymmetrical degrees of stickiness*, *selective learning* and *imported dynamics*. This analytical framework is developed in chapter two, subsections 2.2.1 through 2.2.3 respectively. Here a shorter introduction is in order.

Asymmetrical degrees of stickiness refers to situations where the need for accommodation may well be recognised by key actors, but where it is still difficult to apply this insight because some issues of reform are easier to push through than others. To understand why some issues are more sticky than others, I combine a “policy determines politics” perspective with a variant of new institutionalism known as historical institutionalism. Contributors to the historical institutionalism literature have put significant effort into detecting mechanisms that account for inertia.⁴ A key challenge that comes out of this is to gain a better understanding of when such mechanism may apply and when they are more easily overcome or do not apply at all. It is a basic premise of my discussion that this in turn has to do with properties of the policy in question, i.e. policy determines politics.

The clearest example of this type of logic in the case under study here is the relationship between credit controls and interest rate policy: The expert advice produced before liberalisation had made it very clear that a lifting of credit controls presupposed doing something about the cost of borrowing. This is uncontroversial and basic economics. If you want to curb the flow of credit going into the economy after taking supply side restrictions away, you have to utilise the price mechanism. Still the political reality was that it was relatively easy to lift credit controls but very hard to push interest rates upwards. It was equally hard to change the deductibility rules. This

⁴ Hence a title like Genschell’s (1997) “The Dynamics of Inertia”.

held even when credit supply skyrocketed. Obviously these issues, deeply interdependent in functional terms, were subject to different political logics. Interest-rate and tax policy proved to be sticky, while credit controls were much less so, hence the term asymmetrical degrees of stickiness.

On the other hand, selective learning refers to situations where there is ignorance about, or at least insufficient understanding of functional interdependencies. In these instances the need for co-ordination in the shape of mutually accommodated adjustments of policies is not even perceived by the relevant actors. In earlier work on Norwegian credit policy I have sought to contribute to the debate over ideational factors and “social learning” (Tranøy 1993a, 1994b, 1998). This work developed and discussed the notion that technocratic learning is a process that may cause policy change. Here, by emphasising the selective nature of learning, I want to signal a different focus. Namely on those biases of the technocratic learning process that increase the likelihood of oversights before and during liberalisation. I will identify biases at two levels. At the highest level of abstraction we can detect biases that characterise learning processes in technocratic environments in general. At a less abstract level we can also speak of biases that are rooted in the nature of economic knowledge production.

The most obvious case at hand here is the relationship between letting banks compete more freely and the functional need for taking precautionary policy more, not less, seriously. In other words after lifting credit controls and liberalising concession policy there was a need to enforce stringent capital adequacy standards and allowing a build up of loan-loss reserves. In the old regime credit controls, motivated by the desire to perform macro regulation, also had a micro impact. They forced the banks to ration credit fairly stringently, thus reducing their capacity for risk taking. For this and other reasons, Norwegian banks suffered negligible losses in the period from 1945 up to the mid-eighties. The regulators did not appreciate this point. What happened was that precautionary policies were relaxed as the banks started to grow much faster. Growth rates of 20 to 40 percent per year create a strong demand for own funds. Subsequently the banks sought and gained permission to “fill up” existing requirements with various

types of loan capital. This was tantamount to allowing them to scale down their defences against future losses just as risk-taking was on the increase. In the case of loan loss reserves the banks actually sought permission to increase these. If they had been allowed to do this it would have strengthened their capital base. This issue, however, the authorities interpreted predominantly in the context of a tax discourse (loan loss reserves were not fully taxed) and permission was not forthcoming.

Finally, when I speak of imported dynamics as a source of disparate policy paths I refer to situations where events outside the polity have substantial impacts on domestic policy co-ordination. Imported dynamics can reduce the capacity to co-ordinate policies in at least three ways. First of all imported dynamics can be decisive for the *timing* of policy change. In international co-operation states often commit to timetables and deadlines. Furthermore, in economic policy in general international market developments can act as triggers for policy change. Secondly, external forces can have significant influence over the *content* of chosen policies. International agreements like the EEA treaty for instance produces a stream of fairly well specified measures that Norway is obliged to implement. Policy-making is also influenced in a subtler manner, by the import of ideas and appropriate solutions from abroad.

Thirdly, external commitments can bring a quasi-constitutional quality to policy choices. Much is made of how the EU is a dynamic organisation pursuing new aims and creating new policies for its member states. Focusing on content and timing captures this dynamic aspect of Norway's relationship to the EU. It should not be forgotten, however, that obligations taken on through treaties can also introduce an extra source of stickiness or even downright *rigidity* to policies. Even unilateral commitments can produce rigidity. This is the case when a unilateral fixed exchange rate regime is undertaken to build up credibility vis-à-vis market actors.

Exchange rate management is traditionally understood to be a means to higher ends such as employment, growth or macro-economic stability. When countries link up to, or participate in international exchange rate regimes however, this makes it harder to subordinate the commitment to a stable exchange rate to domestic goals. Still states tend to hold out and suffer disruptions to their national policy co-ordination for a

while, because it is in the nature of the commitment that they must do so. It can be very hard for policy makers to find the right breaking point: The point where the (nationally accrued) costs of upholding the commitment outweigh the reputational costs of breaking it. Both the history of the gold standard and the history of the ERM demonstrate this clearly.⁵

1.2 The argument in context

So far I have presented this study by emphasising what I intend to do. In this section I will seek to contrast my efforts to other, related efforts. As already stated, this project speaks to two separate discourses. The first subsection seeks to outline how this study fits into a broader theoretical context. The second and third subsections look at other empirical efforts to understand credit liberalisation and the banking crisis. After thus having tried to establish what sets the approach developed here apart from various existing literatures, I will give three reasons trying to argue that the effort is at all worthwhile. This is done in the last subsection, 1.2.4.

1.2.1 Theoretical context

In this subsection I will briefly contrast my perspective to other approaches to the study of policy failures. I will also outline some key differences between this project and what I consider to be mainstream perspectives in (comparative) political economy.

Two other approaches to the study of policy failures in the realm of regulatory and macro-economic policy stand out as likely objects of comparison for an inclusive, macro-oriented study like the present one. First of all, analyses of policy failure and fiascos often take a neo-liberal point of departure (Gamble 1987, Bovens and 't Hart 1996).⁶ In this view the big government of the post war welfare state era is an

⁵ See Eichengreen (1985) for an authoritative history of the inter-war Gold Standard. For an analysis of how the pursuit of (gold) parity devastated the Norwegian economy in the mid-1920's see Hanisch (1979).

⁶ This type of critique which has dominated the discourse on government and bureaucracy in the 1980' and 1990's is actually labeled neo-conservative by Bovens and 'tHart 1996. In the generic sense that both these scholars and I use our respective terms this difference in choice of words does

inherently bad thing. Big bureaucracy is seen as wasteful in terms of time and other resources. The intervention it is instructed to engage in perverts efficient market allocation. Its many rules and regulations impinge on individual rights. Demand management is seen as harmful because it creates inflationary expectations and counteraction from economic agents. Finally and most crucial for the argument made here: Big government is self-defeating because beyond a certain size it becomes impossible to co-ordinate policy across a multitude of programmes and actors (Hayek 1982, Østerud 1998).

A second and newer perspective can be derived from the fast growing literature on globalisation, internationalisation and europeanisation.⁷ This literature does not address policy failure directly, but more often than not it postulates such a general pessimism on behalf of successful governance that it can be used to this analytical end. If the neo-liberal perspective essentially complains of “too much government” inside national boundaries, the globalisation perspective essentially focuses on problems that stem from having “too much market” on an international level. In this view outside pressures shift the distribution of power away from governments (and some social actors) towards multinational corporations and financial markets (which in turn are dominated by multinational financial institutions). This process is said to restrict the room for government action by creating new imperatives for economic policy.⁸ In

not conceal significant differences. The reason behind our divergent terminological preferences is probably that my interest lies more in economic policy and theories thereof, while Bovens and tHart deal with public policy more generally. The “constructive” part of the discourse which identifies solutions to many of the problems identified by neo-liberals and neo-conservatives has come to be known under the name of “New Public Management” (Olsen and Peters 1996)

⁷ The distinction between the neoliberal and globalisation challenges to modern government is taken from Østerud (1998).

⁸ Globalisation theorists in effect tell us that governments in the long run will have to pursue the policies that neo-liberal political theory have been saying that they ought to pursue, because such policies are said to conform with the preferences of the ever more powerful market actors. We can distinguish between those globalisation theorists that approve of this (e.g Omhae 1991), and those who disapprove (e.g. Crouch and Streeck 1997). Among those who approve there will be less emphasis on the link between policy fiascos and globalisation. In this view governments can fail in formulating policies only until, through a process of trial and error or natural selection, they “learn” what they “have to do”. The normatively less enthusiastic proponents of the globalisation thesis will on the other hand be more inclined to view a globalised state of affairs as a permanent high risk situation for policymakers.

everyday political life this can be interpreted as complicating the political calculus by reducing the boundaries between foreign and domestic economic policy making. In addition it increases the crisis-proneness of governments. This is the case when a freely traded currency (and the economy it represents) are thrown into a downward spin when for some reason investors collectively leave an asset market and a currency in a hurry.

While trying to hold on to some of the real insights contained in these perspectives, this dissertation seeks to develop a more complex argument. The villains in my story are not big government or increased international market pressures per se. In stead the sources of failure lie in the attempt to reform core economic policy routines in a context of a rapidly internationalised market. Big government may lead to co-ordination problems but these will tend to multiply when the state actually tries to disentangle itself from some of its commitments. When this is done while the state at the same time is trying to learn to live with a more internationalised economy, co-ordination becomes even more difficult to achieve. In periods of rapid change old policy routines will be exposed to new contexts partly of the reforming state's own making. It is the managerial challenges created when many policy variables long routinised are brought into play at same time, creating a functional need for mutual adjustment, which lie at the heart of the problem studied here.

This emphasis on the difficulties of managing change is not compatible with the neo-liberal notion that there is one "right" (the free market) and one "wrong" (interventionism) way of doing things. From a long standing research trend in comparative political economy we can in stead accept the proposition that there are many potentially stable policy constellations (or policy regimes) to be found within capitalism.⁹ These vary across time and space. In the case of the social democratic

⁹ For a very explicit and clear attempt at fleshing out what he calls the "varieties of capitalism" from an influential writer see Soskice (1999). Soskice employs a notion of "institutional equilibria", when describing how different models of business and political decision making are in harmony with their respective national institutional frameworks. It will, however, be argued below that this language does not lend itself to my purposes as it presupposes a theory of action too rationalistic to capture the wide range of behavioural patterns investigated here. The most often referred to "classic text" for the growing body of literature that study "capitalisms" rather than "Capitalism" is Schonfield 1965. For a review of this literature see Hall (1997).

credit regime in Norway we can speak of a stable period running from the early 1950s to at least the late 1970's. In the next chapter I expand on the Norwegian regime. At present I am interested in a more general point: From the notion of stable regimes, I develop the argument that periods of transformation are more prone to crisis and failure. From this it also follows that it is too early to diagnose the age of globalisation as a period of permanent government weakness and increased propensity to fail in economic policy. Globalisation, internationalisation and Europeanisation have made economic steering more difficult by reducing the boundaries between the national and international levels. Still there is scant reason a priori to preclude that new stability can be found. It is conceivable that new routines at the national and international levels can develop gradually, and I will return to this topic in the conclusion.

Having drawn this contrast to alternative theoretical approaches in the study of policy fiascos, it is worth returning to how this study departs from mainstream American (and American inspired) comparative political economy. As indicated in the introductory paragraphs, my argument is that this study does so primarily in two respects. It focuses on a process of transformation as opposed to reasoning within a comparative statics framework that assumes away problems related to the process of transformation from one steady state to another. Secondly it focuses on unintended consequences as opposed to successful purposeful action.

The spread of comparative statics models reflects that it is deemed more important to theorise the workings of a model in equilibrium, and its determinants, rather than going into what can often seem to be insignificant detail and short term adjustment problems. Such a priority is obvious if the aim of the study is to account for durable patterns of variation across space. This has indeed been the traditional concern in the study of national models of finance, social policy and incomes policy, to name three prominent strands of research.¹⁰ One could, however, venture that problems

¹⁰ For national financial systems the standard work is still Zysman (1983). A standard work in the social policy of social democracies is Esping-Andersen (1985) A typology of welfare states was further developed in Esping-Andersen (1990). For a study that takes a real broad tack, including incomes policy, industrial policy, and macro economic policy see Katzenstein 1985 (who deals with small European states) and Hall 1986 (who concerns himself with Britain and France, and to a limited degree, West Germany).

related to implementing regime change is more easily noticed by studies that seek to account for change over time. Notermans (1993) Moses (1994) and Pontusson 1994 are examples of authors who write about the transformation of the social democratic economic policy regimes in Norway and Sweden from an historical angle. They all try to identify the crucial variable(s) that can account for changes in policy regimes.¹¹ These authors also illustrate an interesting methodological point. It is quite feasible to combine a great command of historical detail, and in Notermans' and Pontusson's case, a rich description of how tensions and contradictions can build up within the "old" regime, with an implicit understanding of the actual regime change as a smoothly implemented process.¹²

In essence then, most of the established theoretical contributions reason backwards from outcomes, or even impacts, via power and purposeful action to some kind of interests, functional imperatives or world views. In turn these are shifted by political and economic change in an earlier time period and/or at a different level of analysis. Thereby an assumption that sometimes remains implicit is made: While policy is still at the formative stage, winning actors or coalitions of actors emerge, and these act purposefully and successfully in shaping outcomes. This is all I will say by way of introducing the theoretical context of this thesis. But the issues discussed here will, obviously, be returned to and elaborated upon in chapter two, the theory chapter.

1.2.2 Banking crisis research

Above I discussed approaches that are of relevance because of theoretical affinities between them and the present project. I will now move on to works that are important because they deal with more or less the same substantive problems as I do

¹¹ On the Scandinavian peninsula (in the case of the first two mentioned) or the strategy of Swedish labour more generally in the case of Pontusson.

¹² Notermans singles out cumulative inflationary pressures as a source of a double institutional break down (in credit market regulation and incomes policy) which forces politicians to act. Then they duly install a new regime, centred on an inflexible exchange rate policy. This harms labour, but it is still deemed necessary to break the inflationary spiral and is thus the product of intentional action. Moses agrees with Notermans conceptualisation of these outcomes, but disagrees with respect to what independent variable to focus. He highlights the advent of capital mobility as an exogenous shock to exchange rate policy and argues that this forced the hand of policy makers.

here: Credit market liberalisation and the Norwegian banking crisis. An interested observer from outside the circle of researchers engaged in these areas might wonder which questions are left to ask? The point of this subsection is to be as explicit as possible about the ways in which the present analysis builds on previous work, and to what degree it asks new questions. I will discuss the body of work concerning itself with the banking crisis first and then move on to my own previous work on credit market liberalisation (in 1.2.3).

I will bring up three issues related to existing research on the banking crisis. Firstly, the significance of most of the political (non-)decisions that I seek to explain here, were first pointed out by commissioned research on the banking crisis. Therefore a bibliographical paragraph is in order. Secondly, the debate amongst crisis researchers and economic historians has generated several controversies. Two of these must be addressed in this thesis: One on the relative merits of micro versus macro level explanations of the crisis, and one on the blameworthiness of those responsible for the contraction of economic policy in the late 1980's. Thirdly, it is useful to look closer at the explanatory focus and implicit use of theory in the existing literature.

As we shall see in chapter five, the banking crisis culminated in 1991-92. Consequently, the first wave of analyses that could work from the premise that there was a true system-wide crisis going on, was published in 1992. Two important reports were finalised that year. In the spring, a group of researchers from the Norwegian School of Economics and Business Administration presented what amounted to six case studies of different aspects of the crisis (Johnsen et al. 1992). The Ministry of Finance commissioned this research. Most of the topics discussed in the present thesis (and more) were dealt with: Macro-policy, precautionary policies, bank-to-bank and bank-internal dynamics, and the evolution of accounting rules regulating how losses should be measured and provided for. Later that year a commission led by economics professor Preben Munthe handed in its report. That commission explicitly said that the two groups of researchers had not been very successful in co-ordinating their efforts

(NOU 1992:30:6). Even so, where the reports overlap in terms of substance, agreement between the two works is more noticeable than possible disagreements.¹³

There are, however, some differences in the priorities of the two reports. The commission led by Munthe did not do case studies of individual banks, aiming in stead to paint a general picture. This it did by focussing on issues that affected all banks, such as macro-economic trends, the wave of bankruptcies that swept over the Norwegian economy, and asset price inflation and deflation. Taken together, the two reports had dealt with most possible issues that concerned the banking crisis. Bank profitability returned from 1994, interest in the causes of the crisis seemed to wane. Then an economic history professor, Tore Jørgen Hanisch (1996) published a book where he reprinted an article from 1994, which contained a section on the banking crisis. In book-format, his views got big press coverage, and the debate blossomed up again. The initial article's main contribution was to focus sharply on the role of flawed policies. While the contributions published until then had been distributing blame between banks and the state in an even-handed manner, Hanisch (1996:211) chose to come down firmly on one side: "The state must carry the bulk of the responsibility for the crisis".

In turn, people who had lost either money or prestige (or both) when the value of the shares in the biggest bank's had been reduced to zero during 1991-92 (see chapter 5) seized upon this. Two more issues were raised. Firstly, whether or not the accounting rules introduced during the crisis had been instrumental in "creating" the crisis.¹⁴ Secondly, the specific question was also raised whether the state had been legally justified when taking over control of the biggest bank, DnB, without compensating shareholders at all. The term "bank robbery" was used by some of the

¹³ Earlier investigations into the banking crisis include Reve (1990) and the (classified) report of the so-called Wiker-utvalget, which was mandated to look for legal offences in financial institutions that had suffered significant losses. For longer contributions to the banking crisis debate from some of the key actors themselves, see the chapters in NORAS (1992) by Gunnar Berge (Labour minister of finance 1986-89), Hermod Skånland (central bank governor 1985-93) and Kåre Willoch (Conservative Prime Minister 1981-86).

¹⁴ At this point it was probably highly significant that Preben Munthe, when interviewed by the papers about Hanisch' book publicly expressed the view that his commission had probably underestimated the role of accountancy rules in producing the crisis.

antagonists (Damman 1996). This in turn led Parliament to commission its “own” investigation, led by professor of law Eivind Smith. The report was delivered in June 1998, with the awkward name: *Rapport til Stortinget fra kommisjonen som ble nedsatt av Stortinget for å gjennomgå ulike årsaksforhold knyttet til bankkrisen* (Dokument 17: 1997-98).¹⁵

Soon after this report came out, two historical case studies on the biggest banks in Norway during the 1980s, DnC (Lie 1998) and Kreditkassen (Knutsen et al. 1998) were published.¹⁶ The commission’s report did criticise the state’s actions in some respects, but it defended both the accounting rules, and the specific decision to take over the shares of DnB. Archival findings from the two historical case studies also indicate that the change in formal rules was more dramatic than the changes in practices, anyway. That is, the banks had to a large degree been using the old rules in a way which resembled the letter of the new rules, before the new rules were formally implemented (Knutsen and Lie: 2000:24).¹⁷ Finally, Hanisch et al. (1999) came back with a co-authored book in 1999, re-emphasising the role of macro-policy in a more detailed historical study.

The key causal issue for the present study, is, of course, the role of policy in producing the crisis. The simplest issue is that of precautionary policy. Every single

¹⁵ In this text this report is referred to as Dokument 17.

¹⁶ Lie and Knutsen have also published a joint summary of their findings and views as regards the crisis (Lie and Knutsen 2000).

¹⁷ The debate over the size of the losses and different estimates of “net losses” in particular is highly complex. The statistical material available is inadequate because different banks have used different principles in their financial statements (Dokument 17:106). It is for instance not obvious how one should go about it, if one wanted to net new actual loan losses in one year against loan loss provisions from previous years in order to arrive at a measure of net losses. And taking gross losses minus write-backs is even more complicated. Part of this last discussion is not even particularly interesting as it is extremely sensitive to which principles one calculate according to, in particular the time-frame applied. As the business cycle turned some bad loans “returned” to the bank’ balances, but this does not alter the fact that some sort of accounting rules must always apply and that according to these the banks were insolvent at the time they were taken over by the state. See Dokument 17:89-123 for a very thorough discussion and analysis of this and other topics relating to the degree to which the banking crisis was influenced by the accounting standards applied at any given time. The general conclusion of the Commission is that the crisis was a real phenomenon. “The commission can find no basis for saying that accounting rules caused the crisis. Accounting rules did not cause the great number of defaulted loans and bankruptcies” (Dokument 17:13).

contribution mentioned discusses this issue. They all conclude that if capital requirements had not been debased, the crisis would have been smaller. Similarly there is full agreement that the supervisory body was too weak for too long (both these issues are dealt with extensively in chapter four).

The decisions which lead to pro-cyclical policies in the boom phase (primarily tax, interest rate, and fiscal policy – see chapter three) are also broadly criticised. Here the different works differ somewhat in emphasis, as the discussion slides from one of causality to one of responsibility and blameworthiness. Some authors - such as Lie, Knutsen, and the Smith- commission - insist that in the final analysis the banks must carry a prime responsibility themselves. In short they believe that a bulk of the losses could have been avoided if the banks had shown better craftsmanship.

Others, such as the Munthe-commission from 1992 and Hanisch et al. are more inclined to put emphasis on the macro-arguments. These authors would also claim that with a better management of the business cycle banking losses would have been smaller. The point can be expressed in methodological terms. Those emphasising micro-level causes see sufficient variation in degrees of loss making between different banks and units to claim that there was room for choice at the level of the individual decision making unit. Those emphasising macro causes see sufficient uniformity (Norway's four biggest banks in the 1980s had lost all their equity and fallen into the arms of the state by 1992) to claim that there were powerful macro level forces at work.

The main point for the present analysis, however, is that none of these contributors denies that policy played an important causal role in the boom phase. And to do so would have been dubious, as dubious as to ignore the role of the banks. This is so because what all the authors are trying to understand is a complex interaction process over a long period of time. Macro explanations focus on the incentives and constraints faced by the banks in the shape of credit-demand and funding costs. Or if seen from the perspective of borrowers: Incentives in the shape of the price for credit and the value of their collateral. Micro-level explanations on the other hand focus on cognitive, organisational, and strategic processes at a bank-internal level. Also, the

macro-micro debate has elements of a structure-agency debate: The aggregated effects of the banks' actions at T_0 (extending large credits), had serious impacts on the business environment, i.e. the "structure" within which they acted at T_1 . At the same time the authorities influenced this structure at any given time, through decisions and non-decisions in macro and precautionary policy.

A useful metaphor could perhaps be that while the authorities were responsible for the quality of the road, the banks were doing the actual driving, while both parties influenced the flow of traffic. The dual role of precautionary policy complicates matters further. On the one hand more demanding capital requirements could have slowed down traffic and thus reduced the risk of accidents. On the other hand, if an accident was to occur regardless, they would have served as airbags, limiting the degree of damage done. But there is a difference between explaining why an accident occurs and explaining the degree of damage done. In such a complex causal story it is still valid to claim that the banks had a superior moral responsibility for protecting their investors' and depositors' money (an obligation to drive carefully). But there is limited value in trying to ascribe causal primacy to either set of actors or indeed the structure.¹⁸

In the discussion of the contraction the distinction between causal relevance and blameworthiness gets even more important. Again none of the authors wishes to claim that the brutality of the contraction did not have a causal role in bringing the crisis about. The point for authors such as Lie, Knutsen and the Smith-commission, however, is that the recession was primarily caused by policies that – successfully – fought inflation, and that this was in itself desirable. In the words of Knutsen and Lie (2000:21):

There is little doubt that there is a clear connection between the increased interest rate load placed on debtors and the banking crisis. But it is an open question whether a significantly different policy would have yielded better results, and it seems unreasonable to claim that

¹⁸ In 1997 the present author wrote an analytical summary of the research available so far for the two groups of historians about to analyse Kreditkassen and DnC (Tranøy 1997). In that document this issue is discussed at length.

contemporary actors should have understood that a different policy package would have been better.¹⁹

The Smith-commission takes this line of reasoning further, claiming that the authorities' responsibilities ends with the policies of boom, and does not extend to the policies of bust. This argument will be discussed – and countered - in detail in chapter seven (in section 7.1), where I relate the issue of blameworthiness to the distinction between failures and fiascos (see also section 1.3.1). Suffice it here to say that the no-choice argument presupposes that one reads the actions of key decision-makers into a particular historical trajectory: The implicit assertion is that the path shaped by the inability of decision-makers to quell the boom of 1984-87, forced their hands later on. As already stated, however, this thesis also seeks to grasp a bigger picture than individual choices, blameworthy or not. The focus on co-ordination makes it interesting that the actors landed themselves in this situation in the first place. By taking a systemic co-ordination centred perspective the issue of why the contraction came to be so brutal and harmful for the real economy is reconstituted as an important question.

The final issue that need concern this brief review of established banking crisis research is the following: What causal questions are dealt with and which are ignored? It should be clear from the following that all of the authors discussed above have concerned themselves primarily with understanding why the banks experienced a dramatic decline in profitability at the beginning of the 1990s. The effects on bank profitability of choices made in banking and politics is explored. These factors are also, as we have seen, to some degree weighted against each other. Some of the work does, tentatively at least, also ask why these choices came to be made. There is, however, an asymmetry here. The parts of the analyses that focus bank-internal processes are much more concerned with going one step backwards in the causal chain than those that focus on public policy.

In the bank-centred case studies in Johnsen et. al (1992), and in the works of Knutsen and Lie, bank-internal processes are to some degree interpreted in a context of

¹⁹ My translation.

organisation and strategy theory. Poor craftsmanship and bad decisions in the banks is not just described, an explanation is also attempted. Several relationships on the level of individual banks and the banking market are explored in this literature. A brief summary should include at least the following factors: The cultivation of a new salesmanship oriented strategy, the relationship between fast paced growth and diminishing relative administrative capacity, and the logic whereby fast growth forces banks to compete for more risky engagements. These topics are discussed further in chapter four in subsection 4.2.1.

In the policy-oriented analyses (that is those that engage macro and precautionary policy), most of the analytical energy is spent on the relationship between bad choices and the crisis. In the main, policies are described. This is done one by one. Policies are not seen in relation to each other, concepts like regime or regime change are not invoked. There are also, however, fragments of explanation to be found, as will be obvious from my use of this material in chapters three to six. In both the work of the commission led by Munthe (NOU 1992:30) and in Dokument 17, the lack of stringency in precautionary policy is placed in a broader historical context, and the motives of key actors are indicated. Given the nature of these reports, however, these elements of explanation are neither integrated with each other, nor theorised.

Only one attempt is made at seeing larger parts of the policies pursued as a whole. In his book on DnC, Einar Lie explicitly addresses the issue of how policy came to be so expansive in the 1984-86 period. This is done in a typical historian's fashion, avoiding explicit use of theory. But there are several insights of importance to the present analysis to be found there. I quote from and build upon Lie's analysis in chapters three and six, on points such as the role and motives of different parties on the issues of interest rate controls, fiscal, and tax policy. Finally, the explanatory focus in the work of Hanisch et al. should be considered. Their book is actually marketed as a textbook in the history of economic policy. Still, the work is a typical case of economic historians writing about policy, rather than political historians writing about struggles over the economy. That is, there are several important descriptions of policy making

and statements, but policy is not an object of explanation in itself. The dependent variable, so to speak, remains the real economy.

1.2.3 Credit market liberalisation

The present project is a direct continuation of my previous efforts to explain Norwegian credit market liberalisation (Tranøy 1993a, 1994, 1995). I came to that material with the expectation that the output - a more liberal mode of regulation - and the outcome – a more liberal market order – reflected the intentional actions of a group of actors or a coalition between different groups and/or changing constraints for political action. Simply put, the approach was to look for intended consequences within what I then saw as one – admittedly broad, but still just one – issue area, credit policy. Consequently the thesis made the observation that credit control and interest rate control policies – although functionally inextricable – were subject to different political logics. But this remained an observation, it was not posed as a puzzle.

The overarching ambition remained to explain credit liberalisation as such, as one big step so to speak. Four main perspectives were used to derive four different hypotheses. Three of those hypotheses singled out different national actors as potential drivers of reform. Departing from statist theory, the first hypothesis formulated an expectation that technocrats would be the leading actors. The argument was that they would have this position because of their expertise in complicated subject matter, and because these policies give rise to a complicated interest structure. The second and third hypotheses departed from societal interest perspectives. One established the expectation that political parties responding to an electoral blue wave would lead the process of liberalisation. The other societal interest perspective focused on the role of (banking) industry. The expectation was that these interests would take the lead because they would want to break free from the shackles of a social democratic regulatory regime. The fourth hypothesis suggested that international financial integration had reduced Norwegian policy autonomy to a point where liberalisation represented an adaptation rather than a choice.

The main conclusion of my work on credit liberalisation was that reform was driven forward by central bank technocrats preoccupied with macro economic governance in general and the fight against inflation in particular. This conclusion was strengthened by the relative weakness of the other hypotheses. Politicians – across the partisan divide - showed little interest in credit market regulation. I did find recalcitrance towards reforming interest rate policy, but this could hardly be interpreted as support for the hypothesis that politicians drove the reform. I also found that organised business interests were surprisingly uninterested in the broader issue of regulatory regime in the credit market. In its dealings with the political system, this sector was more interested in day-to-day problems. For example, the size of the state bank sector, and the terms this was allowed to offer in markets where it was more or less in direct competition with commercial banks. Most regime-level opposition was expressed indirectly: In stead of raising a political voice the banks (and other institutions) made use of exit, through evasive actions in the market.²⁰

Finally I found that financial integration did not affect Norway strongly enough to seriously impact the process leading up to the formal decision to liberalise the credit market. It was, and still is, my claim that such a decision was made in 1980, when the recommendations of “Renteutvalget” were more or less accepted by the incumbent government and a majority in Parliament. This proposition is contested, and it will be returned to in chapter three. To make the picture of weak alternative hypotheses complete it must also be mentioned that I did not find that international constraints played a role when the decision to scrap key credit controls was made at the beginning of 1984.

The main point at this stage, however, is that my previous focus on explaining a formal decision took attention away from all the problems that actually occurred when this policy was to be implemented. I devoted most of my energy to highlight the problems the old credit regime ran into in the 1970’s, how these experiences were incorporated into technocratic reflection on credit market regulation, and how finally

²⁰ See also chapter six, subsection 6.1.3 on this point.

these new views gained approval from those formally in power, the politicians. I described how the implementation was marked by indecisiveness, and that it was time consuming (in technical terms the old model was not completely replaced by a neo-liberal regime before 1987). In analytical terms, however, this delay was as a long descriptive parenthesis, not as a problem worthy of investigation in itself. Furthermore, I strove to keep a narrow focus on credit policy, the interaction between credit policy and “neighbouring” policies was never raised.

There are thus both deep commonalities and radical differences between this previous work and the present study. The most important agreement is that I am still interested in technocratic versus societal power in policy making pertaining to the credit market. I also seek to gauge the impact of international forces on this policy making. And a notion that was suggested through induction in the older work – namely that economic crises can help move reform proposals from the technocratic drawing board to the table of decision-makers – is theorised and further explored in the present work.

There are, however, also important differences that separate the two projects. Three key differences can be summed up by the terms unintended consequences, interaction effects and a plurality of policies. In the original project I was interested in goal directed action within one issue area. In this study, focus is on the unintended consequences that flow from the interaction of several (more or less goal directed) actions, within all together 11 policy areas. The time frames and temporal emphases are also different. For most policy areas the present narrative begins around 1980, emphasis is on the last half of the 1980s, and the epilogues bring the story up to the end of the 1990s. The older work began with the inception of what I call the Social Democratic Credit Regime (SDCR) in the 1950s. The main focus was, nonetheless, on how this model ran into problems in the 1970s, how this prompted technocratic learning and finally, the translation of this into policy in the first half of the 1980s.

To sum up then, the effect of policy on the banking crisis is well understood. At the same time, the actors and motives behind credit liberalisation have been analysed in some detail by the present author. What is not well understood, however, is why policy

co-ordination was lost for such a long period. In simple terms, no one has made the policy fiasco of 1984-92 their object of explanation, and that is what I intend to do here.

1.2.4 Potential significances

What then, are the potential significances of the approach I have chosen? There are at least three good reasons to focus on co-ordination failure in economic policy making. The first is that the case in itself suggests this kind of analysis. A close inspection of the Norwegian track record in the years from around 1984 to 1993, and the following normative debate about who is to blame for what, is a problem that invites analysis. How can we as political scientists begin to make sense of outcomes that were strikingly sub-optimal and wanted by nobody? The second reason is that Norway's problems were not unique to this country. Several advanced capitalist economies - Sweden and Finland to take the closest examples - went through comparable problems when they liberalised their credit controls.²¹ The present case study may thus be interpreted as part of an effort to grasp a bigger picture of the kind of problems loose coupling of policy gives rise to in processes of liberalisation and Europeanisation. Thirdly and most speculatively, financial reform and financial instability show no signs of disappearing as lock-step phenomena in the world economy as such. This raises a challenge to a discipline that has so far mainly concerned itself with comparative statics. It is thus my hope that some of the theoretical ideas in this thesis are presented on a sufficiently high level of abstraction to be of potential use in such an effort.

²¹ For an earlier attempt at grasping the dynamics of co-ordination failure with a comparative perspective on the Norwegian and Swedish cases, see Tranøy (1999). I have also analysed the Swedish banking crisis as a policy failure, using the framework developed here (Tranøy 2000).

1.3 Notes on Methodology: What is a policy fiasco and how do we study them?

I have three aims with this section. The first is to establish an object of analysis; to compare my case with abstract criteria in order to decide that the policy episode in question can be labelled a fiasco. This is done in subsection 1.3.1. Further it is my aim to explicate the causal ambitions of this analysis: The main point is that this study is primarily an attempt at a historical reconstruction of a complex process rather than a reductionist attempt at isolating crucial correlations for the purpose of making generalisations. I will argue that this level of ambition is related to the (ontological) issue of how we understand fiascos in the first place. If normally, and legitimately, we understand fiascos as brought about by a failure to co-ordinate functionally interdependent elements of a larger system, this has clear implications for what kind of methodology is available. This is discussed in subsection 1.3.2. Thirdly, I will, in subsection 1.3.3, offer some brief reflections on my use of sources and how I interpret them

1.3.1 Definitions: From failure to fiasco

The Oxford reference dictionary defines a failure as “non-performance of something, lack of success”. By this standard most policies fail more or less, if one cares to look, which is what people engaged in policy evaluation do. Definite achievement of clearly specified goals does not occur often, and in this is part of the reason policy evaluation and implementation- studies is the cottage industry that it is in political science. A fiasco, however, is something more than a failure to reach goals. Returning to the dictionary we find the following definition. “A complete and ludicrous failure in something attempted”. We sense that a fiasco is more dramatic, more instantly recognisable and more complete. Bovens and ‘tHart (1996:15) have sought to capture the essence of the concept using the language of social science:

...a negative event that is perceived by a socially and politically significant group of people in the community to be at least partially caused by avoidable and blameworthy failures of public policymakers.

This definition provides a good starting point for delimiting the class of phenomena that we can call policy fiascos. It establishes three criteria for distinguishing a case that qualifies for the term. Briefly put, we can distinguish between (1) the establishment of an outcome as a negative event, (2) establishing a causal role for public policy in producing this event and (3) that the political actions implicated by this understanding of causality were *avoidable* and therefore worthy of blame.²² The third criterion can also be used to draw an analytical line of demarcation between policy failures and policy fiascos. This entails that policy failures in this thesis will be defined as negative events where public policy played a causal role. Policy fiascos, on the other hand, include the third criterion. That is, the events were avoidable. That an event is deemed avoidable is what makes it worthy of blame and therefore potentially highly politicised.

The first criterion in the above definition - that the negative event in question needs to be perceived as such by significant groups - highlights the obvious advantage of having a case where there is a high degree of intersubjectivity in recognising it as a fiasco. In the case of the fate of the Norwegian economy in general and the banking crisis in particular, this criterion is easily met. With the exception of some former employees and share holders who contest the grounds on which their jobs/share value was lost, it is an overwhelming consensus that there was a real banking crisis and that this was a negative event.²³ And even these parties would probably readily admit that

²² It can be noted that the project this definition is lifted from is more metatheoretical in its approach than what I want to be in this thesis. The authors were concerned with demonstrating that as “social constructs” policy fiascos have at least four “layers of meaning”. For purposes of empirical analysis however, three of these “layers” can readily be utilised as criteria or indicators. Bovens and ‘tHart take what they themselves describe as a “moderate interpretivist” stance, which means - among other things - that a major ambition of theirs is to “deconstruct” policy fiascos as narratives. Their fourth layer of meaning in identifying a fiasco as a social construct is thus the process whereby blame is ascribed; to analyse from a distance so to speak when the question “who is to blame for what” is being fought over. My ambition is more empirical, and I prefer to leave this phase (or “layer”) in the process that constitutes a fiasco out of the definition, and if anything let the answer be part of my results. I should also add that with an institutional approach like I have chosen here, where the perspective is that the political system as such has trouble handling complexity, the issue of identifying blameworthy actors loses some of its urgency.

²³ The leading proponent of the “the crisis is not real”-perspective is Axel Damman (1991) former Vice-president of Norway’s then largest bank, *Den Norske Creditbank*.

there was a policy-induced boom and bust cycle. Their point would rather be that the banks – given some time to recover and a turning business cycle - actually had the resources to come through this period. That the banking crisis was perceived as real by significant social and political groups is also clear from the number of investigations into its causes which has been initiated from various public bodies.

The second criterion – establishing a causal connection between policy and a given event is a more tricky issue. What causal claims can I as political scientist legitimately pursue and which do I need to take as given? Here the distinction between output and impact is useful. At the most fundamental level this thesis is not about the banking crisis or any other phenomenon co-caused by economic policy. It is an investigation into how and why economic policy is made. The question at the heart of the inquiry is why did macro and regulatory policy in the monetary sphere lose its coherence in the period from the mid 1980s to the early 1990s? What is it with the politics of regime change that can lead to a state of chaos and confusion? As such economic policy (output) is my dependent variable. But in the process of ascribing key properties to the dependent variable, coherence and incoherence, I implicitly make causal judgement about the impacts of policy.²⁴ The notions of coherence and incoherence lose all but their semantic content if we try to see them in isolation from the effects of policy. Logically, one could argue that in certain situations policy can be incoherent without the economy being destabilised, but such an outcome would not qualify for the label of fiasco (the “negative event” criterion would not be satisfied). Therefore I need to operate the premise that in this period, policy output had a destabilising impact on the economy. The causal connection thereby posited between policy and economic outcomes is supported by the research done on the banking crisis. This was made clear in the discussion in subsection 1.2.2.1 above. It is my reading of these studies that all of them can be subsumed under the position that the economic

²⁴ I will use the terms co-ordinated (and uncoordinated) and coherence (incoherence) interchangeably. These two sets of concepts may have slightly different connotations (the first is more associated with process, while the second is more associated with outcomes) but for my analysis this is not important. The way I use the terms here policies that are not co-ordinated will always be incoherent and the other way round.

policy of the period was a necessary, but not a sufficient cause for the a crisis of such proportions to come about.

Returning to the fiasco-criteria, we thus have an event that is generally perceived as negative and which there is also substantial agreement that public policy played a causal role in bringing about. The question raised by the third criterion, if these policy actions were avoidable and therefore worthy of blame is, according to the definitions given above, decisive for whether the Norwegian banking crisis can be classified as a policy fiasco or merely a failure. We have seen that it is exactly on this point that some of the policies that have been causally linked to the banking crisis have been defended. It has been argued that choices made were unavoidable in the sense that the existing alternatives were even less attractive. The issue of avoidable or not, is in essence a philosophical question. The answer depends on how one as an analyst negotiates the tension between voluntarism and determinism inherent to all social science explanations. On a more empirical level it can be handled by trying to establish whether there were viable alternatives at the time the potentially blameworthy decisions were made. For these reasons I will leave my attempt at answering this question to, chapter seven, after the empirical analysis is completed. This will not help me provide a definite answer in a philosophical sense, but at least I will be able to draw on my own attempt at a causally oriented historical reconstruction of the policy making processes when I discuss whether there were viable alternatives.

1.3.2 Constructing an explanation from counterfactuals

As should be clear by now, the causal analysis will be directed towards understanding why the dismantling of a stable regime led to severe inter-policy incoherence. This claim is not of such a nature that it invites an approach that places methodological concerns at the centre. Attention to complexity and a desire to synthesise come at the expense of not being able to apply techniques aimed at isolating the effect of a given variable on the outcome. That is to say, the received goal from experimental research via statistical analyses to more simple comparative designs of the most similar or most different type, cannot be pursued if the design is not geared

towards answering the types of questions these designs can handle (Ragin 1987, Tranøy 1993b).

The causal claim is complex in the sense that it can be broken down into several causal stories that are in a sense independent of each other. This follows from being interested in lack of co-ordination between policies rather than in any given policy per se. The fact that policies were to a large degree formulated independently of each other is the essential problem that drives the investigation. On a higher level of abstraction these events are related after all. They are connected through the general argument that loss of coherence in policy is related to the effort to break out of the old policy regime. But to bring out how the logic of disparate policy paths plays havoc with mutual adjustment between policies I am forced to conduct 11 “mini” case studies ranging from regulatory measures via tax to exchange rate policy. This type of encompassing problematique implies that time and space constraints do not permit a design that could have enabled me to try and isolate the causes behind variation in these policy areas in a methodologically sound way.

On the other hand it should be clear that this effort is not driven by an interest in these mini-cases in their own right. It is the interplay between these policy areas that motivates the study. To sum up, one could say that the individual causal claims that together make up an explanation of how policy lost its coherence, could in principle be studied in a more methods-driven way. I have chosen not to. Partly this is for pragmatic reasons (time and space) but mostly it is for substantial, thematic reasons. There are also important limits to the kind of knowledge which can be won by applying controlled-oriented designs to historical case studies, this last point will be elaborated below.

The methodological choices made here also reflect the author’s position vis-à-vis fundamental issues in philosophy of science. This thesis is not about such issues. And I consider the points I am about to make as close to trivial. Still, being explicit is often an advantage, in particular when one is dealing with issues that have proved to be highly divisive in the history of the social sciences. A brief note on this subject is therefore in order. First of all, this thesis is written on the premise that there are no

objective social laws. This means that the concrete phenomena studied here cannot be subsumed under such, or to be more specific, general theories that are anchored in such laws.²⁵ It also limits the usefulness of applying methodological techniques that more or less assume the existence of such laws, i.e. applying statistical techniques to random samples from a somehow delimited universe of manifestations of the phenomenon under study.

On the other hand, however, the notion, which can be associated with some strands of historical research, that it is meaningful to speak of pure facts or truly singular events, is also rejected. In stead I take the basic hermeneutic stance that interpretation is always part of the social scientist's observation. We cannot free ourselves from preconceived theory and/or making analogies to previous observations. This has several implications. First of all, and counter to an overly idiographic understanding of history, comparison is always part of the process of observation. Combined with the rejection of purely nomological ideals, this leaves me with a position that finds it meaningful to look for limited regularities when one seeks to both describe and explain social phenomena. Secondly, social science theories are ultimately social products, the merits of which must be established on an inter-subjective basis.

In terms of methods this entails that it is meaningful to compare in order to move closer to an explanation, within carefully delimited and small classes of phenomena. But the designs available for such exercises – most similar and most different systems – also come at a cost.²⁶ There are two problems of prime importance. First of all, these designs are geared towards detecting co-variation in small samples.

²⁵ For an excellent review of how different schools of thought view this issue, see Mjøset (2001 forthcoming).

²⁶ See Frensdreis (1983) for a clear presentation and discussion of most similar and most different system designs. In most similar systems one compares similar cases in order to isolate the crucial independent variable that can “explain” difference along the dependent variable. An example could be an analysis that explains the difference in security policy orientation of Norway and in Sweden during the cold war era by pointing to different war-experiences. Most different systems inverts this logic. Here a crucial similarity is sought among the independent variables in order to “explain” similar outcomes on the dependent variable. An example could be an analysis that showed

They can handle neither multiple nor conjunctural causation (Ragin 1987).²⁷ The concept of conjunctural causation, which corresponds roughly to what in the language of statistics is known as interaction effects, is a matter that goes right to the heart of the present study. As I have argued above, the banking crisis must be considered to be the result of a very complex causal process, which in turn has dictated the broad scope of this enquiry into the politics behind it.

The second problem with standard comparative designs is loss of information about the cases. There are two prime reasons for this. First of all comparison across cases along theoretically specified variables requires a fairly high level of abstraction, which means loss of detail in it self. The question for each comparative case project is thus: what constitutes an acceptable trade-off between abstraction and attention to case-specific detail? To this there are of-course no general answers. But we can throw further light on the issue by considering the other information-draining factor that follows use of the comparative method. Namely a need to operate dichotomous variables, and as few as possible, which is an incentive to collapse several variables into “bigger” indexed variables. These pressures follow from the need to maximise degrees of freedom within designs based on a limited number of units. Taken together these problems with designs based on the comparative method indicate that most similar and most different systems are only useful for pure comparative statics. Like the statistical method, and any other tool that is geared towards detecting co-variation, the comparative method is of no help when we want to understand causal processes. That is a task for theoretical interpretation.

To sum up, this is a project based on a design that does not even allow for the detection of co-variation (as in limited regularities) and an epistemological conviction that there is no such thing as grand theory. This places the burden of explanation on the author’s interpretation. This interpretation is based on the idea that our insights into the

that the reason Norway and Saudi-Arabia have similar climate change policies is because the two states share the characteristic of being major oil producers and exporters.

²⁷ The notion of multiple causation i.e. that the same phenomenon can be caused by different factors in different circumstances is not of direct relevance to this study, given the way it has been designed with an emphasis on understanding one outcome.

empirical materials analysed and our theoretical understanding can co-evolve. If there is no hope of establishing grand theory and there is no hope of achieving neutral observations there is no point in insisting on impermeable borders between theory and observation. And if all theories are social products, we must expect that they change not as in refutation or validation, but that they are modified and added on to. This is a position inspired by the philosophy of science of Glaser and Strauss' (1967) and their core concept of "grounded theory". It does not, however, boil down to an "anything goes" position (Feyerabend 1975). There are rules of logical consistency and friendly interpretation to observe when developing theoretical ideas and propositions. Sources should be subjected to careful inspection and critique, and one should strive for clarity and transparency when developing concepts and typologies.

It should also be added that designing the enquiry as a historical reconstruction and interpretation is in keeping with traditions within the field of fiasco-analysis. Reading case stories on policy fiascos (and other types of crises) it is striking how often they are accounted for in terms of series of counterfactuals of the "if only" kind. It seems that when we want to explain a positive human action it is often deemed sufficient to establish a plausible motive force pointing to the decision makers interests, the degree of resources available, the formal rules and informal norms the action was embedded in, or some combination of these. When we, on the other hand, want to explain why something bad was *allowed to* happen a much broader set of factors becomes potentially interesting. And this is exactly the anatomy of many fiasco reconstructions. Fiascos are understood in terms very similar to what we might call a systems failure. This basically means that several more contingencies of the "if only" type is brought directly into the causal argument.

This point can benefit from an illustration: If an executive officer at a high level of a bureaucracy makes a discretionary judgement that has no consequences judged to be seriously negative, we have hardly got a research problem. At best such an event is explained with reference to cost-benefit calculations or norms of appropriateness applied within a framework that is given by the given bureaucracy's repertoire of action and competencies. If, however, the decision, is judged to have had serious

negative consequences, layers of new questions can be opened to investigation, for example: Is the way information flows are organised faulty? Does the chosen action reflect limitations in the available repertoire, or does it reflect bad judgement from the person utilising it? In either case, could the incident have been stopped by superiors or other bodies with monitoring responsibilities? Is there a fault with the monitoring functions of this organisation? Or in the case of extremely poor judgement being shown, is something wrong with the recruitment and personnel policy of this organisation that hindered it in weeding out the individual in question at an earlier stage? And here we arrive at a crucial point: If we assume that any one of these questions could have been answered with a yes, it means that they can be expressed as a counterfactual hypothesis about the causes of the disaster, of the “if-only” kind. If only supervising body x had stopped the decision maker at an earlier point, if only the recruitment division had better suited criteria to work from and so on and so forth. Since the fiasco could have been averted at any one of these points in the causal chain, it means that any of these seemingly small events were necessary conditions for the fiasco to occur.

The point is that fiasco reconstruction makes it salient to cast the analytical net both broadly and back in time in order to locate links where the causal chains leading to the unwanted events *could have been broken*. This is clearly illustrated by Bovens and ‘tHart’s (1996: 62-69) discussion of the Heysel tragedy in Brussels. Here 39 football fans died and 450 more were wounded as riots broke out before the European Cup final between Liverpool of England and Juventus of Italy in May in 1986. Most of the casualties came when Italian fans were crushed trying to escape Englishmen who were attacking them after climbing a fence separating the two groups.

Bovens and ‘t Hart suggests that the analysis of this catastrophe can be broken down into at least five different causal chains that all contain the potential to have prevented the tragic events from occurring: The most immediate causal chain relates to the insufficient policing of the point where trouble started. It can be traced backwards from the belated decision to call for reinforcements made by the platoon commander in charge of guarding the fence that English troublemakers climbed to be able to chase

Italian fans. The officers' hesitation in taking positive action had to do with the fact that he could not reach his immediate superiors. In turn this was because he was equipped with a weak intercom system. His (non)decision is further interpreted in light of the extremely hierarchical structure of the Belgian state police (Gendarmerie). In a slightly less hierarchical organisation - like the Brussels police force - a platoon commander might very well have made a more independent judgement and not waited until the situation was out of control anyway. But as the result of a highly dysfunctional and politically motivated compromise the Brussels municipal police force guarded the other half of the stadium. Rivalry between the two forces also accounts for weak co-ordination between them at the arena. When officials from the Belgian soccer federation wanted to report that something was stirring in the section where trouble eventually flared up they could actually only reach representatives for the municipal police, who in turn could not reach the Gendarmerie.

The other causal chains Bovens and 't Hart mention are the role of the Belgian soccer federation in the implementation of ticket sales which led to an unplanned for presence of Italian fans adjacent to English supporters. Thirdly, the role of the European soccer federation in approving that a match that attracted English following in a stadium with clear deficiencies in terms of infrastructure and facilities. Fourthly, the role of local authorities in limiting the sale of alcohol and the enforcement of rules against public drunkenness. Finally the role of both police forces and private security firms in ticket in verification and search procedures at the stadium gates.

The parallel drawn between this fiasco and Norwegian economic policy in the eighties and early nineties is of course an abstract one. It centres on shared qualities such as the multiple and parallel leaves of decision making and the less than perfect co-ordination between organisational actors with interdependent responsibilities. These are features of a complex causal picture, a picture of a kind that forces us to engage in historical reconstruction rather than control-oriented reasoning.

A nuance in the causal structure of the two stories might be noted. That is, in the Heysel case each of the causal chains arguably contained the potential to have prevented the tragedy. If this is the case the causal picture can be described as one of

near complete contingency: Each of the mistakes were - arguably - necessary conditions for the disaster to occur at all. With a drawn out fiasco like a boom and bust sequence, however, it seems more reasonable to think of causality in terms of an additive model. That is each of the policy mistakes added to the steepness of the curve through the boom and bust sequence, but one could still imagine a significant economic crisis occurring even if one was able to “take away” an element or two from the story reconstructed here. If one shifts one’s level of analysis, however, and see the Norwegian banking crisis as consisting of three causal chains, the parallel re-emerges. Arguably, the crisis could have been averted through better macro policy, better precautionary policy or more careful banking. This means the macro-policy chain, the precautionary policy chain and the banking chain were all necessary conditions for the crisis to occur.

1.3.3 Sources and their interpretation

I rely on three types of sources in this study. Interviews, official documents and secondary literature. In this subsection I will offer some reflections on how I use these types of sources.

In the course of my work on credit liberalisation and the banking crisis I have conducted in-depth interviews with 24 respondents. These have been chosen because of the roles they have occupied in preparing and making monetary and regulatory policy. I have talked to present and former employees of *Norges Bank*, The Ministry of Finance, politicians from all major parties, and ministers from all the governments in the main period covered. I also met with former CEOs from the biggest banks, and the directors of the banking associations. 20 of these respondents were originally interviewed for my “hovedfagsoppgave” on credit market liberalisation (Tranøy 1993a). One individual (former central bank governor Skånland) has been interviewed twice – once for each project. I have made five additional interviews exclusively for this project. This means that the present thesis at several points draws on information

gathered for, but most often not utilised in, the previous project. This will be explained below.

I have conducted something akin to what Dexter (1970) calls elite and specialised interviewing. I prefer the term open and semi-structured elite-interviews. The concept of “structure” is part of the term because for each interview a plan was prepared, specifying which topics and specific questions should be covered during the respective conversations. The terms “open” and the prefix “semi” refers to three departures from fully structured interviews consisting of identical questions, such as is often used for purposes of collecting survey data.

Firstly, each interview produced new information. Information that it was desirable to follow up by new questions there and then. Secondly there was a process of accumulation. This meant that as I got better insight into the processes I was studying, the questions I wanted to ask evolved somewhat. This means that people interviewed late in the process were sometimes asked questions that were not included in the first round of interviews. I did, however, often go back to the first interviewees with follow-up questions. This was mostly done by use of telephone. Thirdly, the interviewees were selected in part because they could be expected to have expertise and knowledge of different aspects of the broad topic covered here, consequently it would not have been meaningful to raise every issue with each respondent.

In sum these considerations reflect that the purpose of these interviews has been to gain insight into the interests and the worldview within which these interests are nested. I have tried to reconstruct a process wherein individuals have reflected and acted in order to achieve their goals and/or do their duty. In order to obtain knowledge of such a process there is no way round letting the interviewees influence both the questions asked and the type of answer given within the framework of a dialogue.

The reason I have drawn on under-utilised material from previous research is related to my motivations for undertaking this project at all. As was pointed out in subsection 1.2.2.2 above, the original project was centred on studying liberalisation as an intended outcome. I was looking for the result of purposeful political action within one issue area. The design of the study also influenced what kind of information could be

utilised. By starting out from a most similar systems design, the argument had to be developed around dichotomous variables, and thus answer complicated questions with a straight yes or no: Was the market liberalised by year 1985 – yes. Did politicians from the Conservative party promote liberalisation – no. This was a legitimate research strategy, and insights can be won viewing liberalisation in this perspective. Some actors wanted it, fought for it, and (eventually) got it. However, this focus also made several new insights acquired during interviews and other source work more or less redundant.

As the first project moved towards completion, the analytical framework it was conducted within also began to resemble a straightjacket. Fascinating pieces of information and new insights had to be downplayed or even downright ignored. Concerning for instance how the effects of intermediary steps were miscalculated or overlooked how ambiguity produced inconsistent actions or how the effects of different policies interacted in a way nobody had foreseen. The list can be made longer: how opposition and support patterns varied across issue areas producing a great gap between decisions and their implementation, or how internationalisation complicated most steps on the way without ever actually being the driving force. This meant that the old project left this author with both a desire to pursue these questions directly, and empirical material to start out from.

In general the areas covered in the present projects are rich in sources. The most relevant academic literature was reviewed in subsection 1.2.2.. I have also relied on other secondary academic sources that address one or two of the policy areas covered. In addition I have supervised students. This provided the opportunity to point students in the direction of highly specified research problems that I – from my own work – knew was not properly covered in the literature. In total this means that I have relied heavily on the research of other people in some sections, which should be clear from footnotes and references. What I have been aiming for, however, is a synthesis. This means that most of the material drawn from other research has been put in a new context, both in terms of description and explanation.

There have also been several committees of inquiry into both credit policy in general and the banking crisis in particular. These reports are generally rich in both verbal description and statistics. In addition to this Proceedings of the Norwegian Parliament are published in full and Norges Bank publishes its Economic Bulletin (*Penger og kreditt*) every quarter. This rich stock of sources has made it easier to check the external consistency of individual sources by cross-checking with other independent sources. The internal consistency of individual interviews have been checked through reconstruction of full narratives and challenging interviewees on unclear points in follow-ups to the original interview.

1.4 How the thesis is organised

The rest of this dissertation is divided into six chapters. Chapter two is theoretical and conceptual. What I seek to explain is an unfortunate mix between continuity and change across several functionally interdependent policies. From this it follows that I need to explore both continuity and change, and co-ordination and co-ordination failure, at a theoretical level. Chapter two thus explores the notion of regimes as stable, functionally compatible entities. Empirical illustrations are given in the form of stylised cases. It is further argued that to achieve a fuller account of the sources of co-ordination failure, we need micro-foundations that sensitises us to actors who fumble and only gradually learn how to operate in a new context. This is in contrast to rationalistic and “natural selection” notions of adaptation. Hence it is preferable to define a policy regime as a set of routinised policies rather than the more heroic concept of institutional equilibrium. The next step is to indicate what mechanisms can be at work when policy co-ordination is not upheld through a reform process. For this purpose the typology of disparate policy paths will be fleshed out in more detail.

Chapters three, four and five make up the historical narrative and as far as possible I have sought to present the case materials in chronological order. The three sources of disparate policy paths provide the other organising principle for these chapters. Chapter three deals with the role of asymmetrical degrees of stickiness in

producing the boom phase. Of the five policies followed in this chapter two proved easy to reform (housing and share market regulation) and two were sticky (interest rate controls and deductibility rules). This sequencing compounded the expansionary effect of liberalising credit controls which was done in the “middle”. The compounded effect arose because rising prices in the newly liberalised markets for collateral (shares and property) interacted with the credit market igniting a process of asset price inflation.

Chapter four brings up other aspects of the same story. It describes how selective learning facilitated the oversights that made management of the boom phase less adequate than what could otherwise have been the case. The chapter demonstrates that the technocracy was not prepared for the effects of liberalisation. Asset price inflation was not on the conceptual map, neither was changed behavioural patterns among banks, firms and households. As a consequence of this neither macro-economic nor precautionary policy making was not even sought adapted to rapidly changing circumstances.

Chapter five tells the story of the sharp downturn, and demonstrates how this was facilitated by policies moved by imported dynamics. Initially the most important dynamic factor is the international oil market. The chapter picks up the story with Norwegian responses to the external shock of plummeting oil prices. This crisis impulse helps both tax reform and interest rate reform get under way. Gradually though Europeanisation takes over as the most important external force. Europeanisation impacts both exchange rate (and thereby interest rate) policy and regulation of the currency market. This chapter also includes an empirical epilogue, which brings the story of Norwegian macro-economic policy making up until the time of writing (January 2000). Chapter six and seven conclude.

Chapter six presents what I call local conclusions. This is done by interpreting the findings made in chapters three, four and five in light of the theory presented in the discussion of the disparate policy paths in chapter two. Chapter seven looks at the bigger picture and discusses broader theoretical issues raised by the thesis. It also includes an “analytical epilogue” which discusses whether the latest developments in Norwegian policy making have the potential to successfully address key issues of co-

ordination so that one can conclude that the framework for new, stable routines is now in place.

Chapter 2: Conceptual and theoretical building blocks

2.1 Routines, regimes, stability and order

One way of expressing the key theoretical challenge confronted in this thesis is to say that I want to develop an argument that links regime change and the likelihood of policy fiascos. My approach rests on the general institutionalist supposition that institutional orders are relatively stable, punctuated by shorter intervals of crisis and dramatic change, after which stability again sets in. This is the so-called “punctuated equilibrium metaphor” (Krasner 1984, see also Olsen 1992, and Thelen and Steinmo 1992). Historical institutionalist research tends to look for the big picture and the long term. “Punctuation” is interesting because it marks the end of one institutional order while it ushers in a new durable order – “...institutional stasis again sets in” (Thelen and Steinmo 1992:15). But as Herzog (1989:39) has remarked, “upon closer inspection breaking points in history are often awfully long”.²⁸ I take this as a call for looking more closely at medium term processes. I make the medium term unintended consequences of a “breaking point in history”, of the kind identified but not in itself focused by the punctuated equilibrium metaphor, my object of study. More specifically, I argue that liberalisation and Europeanisation constituted a major transformation. This transformation entailed moving from a stable regime to a state of flux and confusion. Furthermore this state lasted long enough and had big enough consequences to merit study in its own right.

That functionally interdependent policies are formulated in relative isolation from each other is an everyday fact of political life in advanced welfare states. This can be seen as a function of administrative and political imperatives. Time and attention are scarce resources, inducing sequential treatment of issues. Further, big problems are subdivided into smaller issues. This makes them easier to handle politically and it facilitates specialisation and division of labour. Thus loose coupling of functionally

²⁸ Quoted in Olsen (1992:26).

interdependent policies is not particularly interesting per se. What is interesting, however, is what can happen when loose coupling continues to be the procedure also in periods when core policies are changed. In such instances, otherwise innocent looking sequencing and functional divisions of labour can lead to a breakdown in co-ordination. In the case of the Norwegian macro-economic regime change, policies were set and policy changes were temporally ordered without much regard for their interdependencies. Because of this, a situation arose where policies were allowed to work blatantly at cross-purposes.

The argument above directs attention to the fact that any institutional order rests on a bed of functional compatibility between its component policy routines. The study of change and co-ordination breakdown makes it easier to see how stability is implicitly understood in large segments of the institutionalist and quasi-institutionalist literature on economic policy making. This is a point where the present analysis can benefit greatly from what I have called mainstream political economy. Institutionalised *orders, regimes* or *policy models*, as they are called by different authors, can develop through trial and error processes, and/or they can be the product of (fairly) deliberate planning and design.²⁹ I am not making the claim that institutional orders necessarily tend towards some kind of optimality frontier, even though this is a fairly common assumption in the literature.³⁰ In this respect the argument is more banal than heroic: It says that if policies invariably have impacts outside their primary domain, a minimum level of accommodation between policies must be built into the routines of the institutional orders. If not, such regimes would not be able to endure over time, and a certain endurance is a quality institutional orders have by definition.³¹

Temin highlights the routine and durability aspects of institutionalised orders well when defining a policy regime this way:

²⁹ To achieve some variation on a much-repeated theme I will alternate between the terms “institutionalised order” and “policy regimes”.

³⁰ See subsection 2.2.1 below.

³¹ Conversely, when we want to explain why regime change is set in motion, an important building block in our arguments is often the detection of “new” tensions and contradictions between policies, produced either by a process of gradual accumulation or by an exogenous shock.

The regime is an abstraction from any single policy decision; it represents the systematic and predictable part of all decisions. It is the thread that runs through the individual choices that governments and central banks have to make. It is visible even though there inevitably will be some loose ends, that is, some decisions that do not fit the general pattern.³²

In this chapter I will first consider the idea that economic policies are routinised and thus stable over longer time periods. This is the task that is undertaken in subsections 2.1.1 through 2.1.3. If we can better understand the conditions under which co-ordination and thus stability is achieved, we are also moving closer towards an understanding of how co-ordination can be lost. I proceed by first giving a short review of how the self-reinforcing nature of institutional orders and policy regimes is understood in some of the literature. Then I move on to the particular case of the social democratic macro-economic policy regime that developed in Norway from the end of WW II and to the mid-70s. Finally I will try to explicate the kind of micro-foundations necessary to invoke to in order for the analysis to be consistent with the observations that follow in the empirical sections. The notion of disparate policy paths is developed for the purpose of explaining co-ordination breakdown. This task is undertaken in section 2.2 with subsections.

2.1.1 Functional interdependencies and compatibility

I have claimed that any institutional order rests on a bed of functional compatibility between its component policy routines. This compatibility argument might on first sight seem slightly at odds with parts of the historical institutionalism literature. For many historical institutionalists a key phenomenon sought explained is that institutions have the ability to outlive their initial purposes and usefulness. A key postulate in the often quoted work of March and Olsen (1989, 1994) for example is that “history is inefficient.” This and similar type of arguments is typically developed in analyses of the relationship between institutions and their environments (Genschel 1997). The claim is that institutions do not as a rule adapt instantaneously to changing environments. Borrowing a term from organisation theory (Cyert and March 1963:41-

³² Temin (1989:91) as quoted in Notermans (1995:33).

44) we can say that in resource rich environments there will normally be considerable *slack*. In the present context slack could be defined as the difference between a given institution's potential performance and how well it needs to perform to survive. But institutions are not just performers they also constitute cognitive and normative structures. This means sometimes performance is more or less ignored, the institution is simply taken for granted. Or new stakeholders can introduce new criteria for gauging performance. That is, institutions can outlive their entrepreneurs and create a new basis of support.³³

I do not, however, take issue with this broad stance. To the contrary, I depend on these kinds of arguments when looking at those institutionalised policies that were not adapted quickly enough when a crucial part of their environment - credit market regulation - underwent revolutionary change. At the same time I can not rely exclusively on these arguments: As the empirical chapters will show, some institutionalised policies were changed easily and quickly. Together this created an unfortunate policy mix that made the period of change an unstable one. If we employ a longer timeframe and look at the bigger picture, however, we see that the incoherent mix - the non-regime - was not as long lived a phenomenon as the post war regime it succeeded. Other policies were gradually brought more into line with the functional requirements of a liberalised credit market. And this is a key point: Institutions will often outlive their purposes, and when they adapt, it can be through a relatively drawn out process. It's a half-full/half-empty type of call: A combination of policies that are fundamentally incompatible will not be truly long lived, but in the case under study here such a period was still long enough to inflict serious damage.

Furthermore it should be stressed that my argument that a compatibility requirement must be fulfilled for policy mixes to gel and become regimes, is a relatively modest proposition. A leading economic institutionalist like David Soskice (1999) takes this kind of idea much further when he speaks of *interlocking complimentarties* within (varieties of) capitalist systems that give rise to different types

³³ Inertia inducing factors are discussed at more length in section 2.3 with subsections below.

of comparative institutional advantages. Decomposing capitalist institutions into four systems, Soskice speaks of how each “element of the institutional framework reinforces the others” and “that each system depends upon the other systems to function effectively.”³⁴ In short, Soskice’s argument is about institutional equilibrium and optimal adaptation. The notion that regimes must possess a minimum level of compatibility is, on the other hand, one that allows for significant slack. Slack can serve as a buffer against change. Thus there can be inertia and maladjustment without (immediate) pressure for change.

Another economist who has explored the notion of interdependent policies and institutions is Richard Freeman. After having been called in as a foreign expert to help study the “Swedish Model” (Freeman and Topel 1995), because the Swedish welfare state was perceived to be in a deep crisis, and at a time (early to mid-90s) when the dominating view seemed to be that the fault lay mainly with the older, pre-liberalisation institutions and policies, his findings led Freeman (1995:16-17) to muse:

...steps toward an arguably more efficient economy produced unexpectedly large economic losses, which raises the question: what is it about the welfare state and its supportive economic institutions that makes reform so costly?

His suggested answer is that:

... in a welfare state economic agents are more tightly linked than in decentralised market economies...economic agents, modes of behaviour, and institutional rules in one part of a tightly linked economy adapt to the operation of all other parts and thus will suffer a loss in efficiency when one of those other components change.

As we can see, Freeman’s argument is similar to mine in that he moves from a notion of tight links between institutions, policies and behaviours to a hypothesis about the costs of change. We both agree that if stability presupposes compatibility, it is highly likely that big change in core policy routines demands concurrent changes in other routines for new stability - new order - to emerge. He underscores his argument by elegantly illustrating how various behavioural, political and institutional features of the Swedish model linked into each other in reinforcing ways. He also takes a step towards formalising his argument by applying a model lifted from work that analysed “epistatic

³⁴ The four systems Soskice analyse are corporate governance, industrial relations, inter-company relations and systems of innovation.

interactions in biology”, where the main point is that the marginal product of each part of the system depends on the degree of coupling in the system. In principle this approach would allow for estimating the costs of change, expressed numerically. I am, on the other hand, interested in the mechanisms that produce a reduction in the coordination performance of the system as it moves out of a stable mode, but before it has found new stability.

2.1.2 The Norwegian Regime

In this section I will demonstrate that what I call the Social Democratic Credit Regime (SDCR) can be interpreted as a system that harmonised routines across several policy areas, making them compatible, if not mutually reinforcing.³⁵ First, however, a brief reflection on the exercise of constructing policy regimes as historical abstractions is in order:

When we make the claim that a policy regime has existed, we at the same time engage in an act of temporal and spatial circumscription. Ultimately there are no clear-cut criteria for the analyst to lean on when making these choices. When we observe historical developments in policy, it is always possible to overemphasise continuity at the expense of change and vice versa. Similarly, it is difficult to delimit in any exact way the functional scope of a policy regime. As one studies such a subject closer seemingly minor modifications in the setting of policy instruments can take on new significance, and functional interdependencies that one were previously unaware of can be revealed.

My strategy for arriving at choices in this analysis is to place credit controls at the centre of attention. This is at a minimum a device for organising a narrative, as it is hard to establish criteria that could back a claim that credit controls were more fundamental to the social democratic economic policy regime than other routinised policies such as interest rate policy, fiscal policy or tax policy. On the other hand,

³⁵ My understanding of Norwegian economic policy routines in the post-war era has been profoundly influenced by the work of Mjøset (1986, 1987). This sub-section builds directly on my own previous work, where I made a more detailed study of credit policies in the 1950-80 period (Tranøy 1993 chapter three).

credit controls were fundamental to the credit regime and the economic policy regime more generally in the sense that when credit controls were taken away in 1984, and other policies were not significantly accommodated, this gave rise to increasing problems of macro-economic management.

The SDCR implied a simultaneous pursuit of three analytically distinguishable, politically defined ends. These were stabilisation centred on full employment, state-led modernisation and redistribution. The regulatory framework underpinning these goals was given a major overhauling in 1965, but conceived as a system of enduring, explicitly normative ends and mutually consistent means, the regime existed from 1950 and 30 years onwards.

At the core of the SDCR was the relationship between interest rate controls that kept nominal rates low and stable, and credit controls that kept excess demand generated by the low rates from being realised in the market. Low interest-rates contributed to keeping investments high. It was also a common view that low interest rates favoured investments in real capital over portfolio investments. This was in line with the way modernisation was perceived in the “golden age” of social democracy. Low and stable interest rates also favoured incomes from work relative to “passive” investments in bonds. This was in concurrence with political values of social democracy. The model also entailed tax breaks for interest payments. This pushed real rates downwards, a policy meant to stimulate home construction and investments in real capital further. The authorities were, however, not only aiming for high investment rates, they also sought to stabilise investment levels. The idea was that by way of credit controls and suppressed price levels for credit one secured that there was always a “queue” of projects waiting for the go ahead. This enabled the authorities to “release” waiting investment projects in case of a cyclical downturn. The regime therefore had a clear counter-cyclical logic. An important prerequisite for the SDCR was the deployment of capital controls. This made it easier to maintain a domestically oriented interest rate policy without putting too much strain on the exchange rate. This was always pegged, although with varying degrees of inflexibility. First to the dollar

through Bretton Woods, later to the European currency Snake and then to a trade weighted basket.

A corollary to the active use of credit policy for stabilisation purposes was a corresponding lack of active fiscal policy. In stead fiscal policy was cautious, small surpluses was the routine. This corresponded to the functional requirements of the credit regime in several respects. Firstly it reduced the state's need for borrowing. Deficits and corresponding state demand for credit would have put an upward pressure on interest rates that would have threatened the long run viability of keeping interest rates low and stable. This functional link between fiscal and credit policy was felt in a more painful way by the more spending happy Swedish authorities as early as in the 1950's (Tranøy 1998). Secondly, persistent deficits contribute to money supply growth and make it more difficult to control credit supply without resorting to use of the interest rate anyway. Thirdly, if the state needed to go abroad to finance its deficits, this would have put pressure on the regime of capital controls that "protected" the credit model from external pressure.

In general the low rate of interest influenced savings negatively. This made it more important for the authorities to contribute positively to aggregate savings. Budget surpluses also made it easier to finance the network of state banks. The state banks got further funding through some of the credit controls: Instruments forcing banks and insurance companies to purchase low yield government and government backed bonds served the double purpose of restraining private sector credit supply, and funding state banks and politically prioritised industry at the same time. This meant that the bond market had to be regulated at "both ends", in reality suppressing this market, making it less attractive to be a financial investor in Norway. Similarly the share market was neither large nor very liquid (Flæte 1997), and industry came to rely on bank loans as the major source of external finance. The state banks were the chief instruments for pursuing the ambition of state-led modernisation. They were also used to redistribute funds between sectors, districts and individuals.

The biggest state bank – *Husbanken*- financed house construction. Housing was given very high priority in the SDCR. In addition to direct subsidies through this state

bank, low interest rates and tax deductions for interest payments were officially motivated by the goal of improving tenure standards nationally. Co-operative housing, which received a huge share of the subsidies, was in turn price regulated in an effort to preclude an individualisation of the benefits. The quota and queuing system also opened for a political influence over allocative decisions in the private institutions. Private institutional credit was sought directed towards house-construction at the expense of other purposes, in various agreements between the authorities and banks and insurance companies. Extra stimulus for housing construction could also be linked to stabilisation policy in the case of downturns: For a small open economy like the Norwegian, house construction holds the twin attraction of being both labour intensive and relatively low on import content.

2.1.3 Micro-foundations

Micro foundations and theory of action issues can be considered a specialisation into itself within the social sciences. It is not within my ambitions to contribute to this discourse. Still, I am forced to consider the topic because it is imperative to establish micro-foundations that are not at odds with the observations that first provoked this study. Seen in light of theories of individual rational behaviour I have observations that indicate lack of overview, failure to evaluate the scope of consequences of political action, and limited will and ability to seek out new information. Finally, I have observations that indicate a limited and partial understanding of the causal processes that link regulatory instruments and market behaviour.

I will build my attempt at establishing micro foundations for this study round the concept of *routines*. I use the term in a similar way to Mjøset (1986, 1987) who sought to capture enduring differences in economic policy-making among the Nordic states with this concept.³⁶ I will flesh out this concept by showing that it is possible to

³⁶ Mjøset was building on Nelson and Winter's (1982) theory of decision making in firms. These authors were in turn inspired by the so-called "Carnegie-school" of organisational analysis which counted names such as Herbert Simon, James March and Richard Cyert amongst others. In

subsume several mechanisms under it. Mechanisms that have been developed by various literatures that, one way or another, relate themselves critically to operating assumptions of pure rationality.³⁷ Firstly, routinised action is a kind of *rule following* in the sense that situations are defined as belonging to this or this class of events, to which pre-existing appropriate routines apply. Within institutional actors such as state agencies and political parties, routines can also be seen as embedded in larger *frames*. These help decision-makers edit away causally “irrelevant information” and help establish (normative) priorities. I will also assume that routinised action implies a tendency to decompose problems and possible solutions and accord attention to them sequentially. In the purer, theoretical literature, rule following and choice based on (expected) consequences are often presented as analytical opposites (March and Olsen 1998). For my hands-on purposes of historical reconstruction it is more practical to see routines as implying an element of post hoc, *satisficing behaviour*. This would mean ascribing to decision-makers a willingness to critically examine their routines and experiment and/or attempt to act in a more strategic and calculating manner if certain performance criteria are not met after standard operating procedures have been applied to the problem in question.

All these limitations in the rational capacity of individual institutional actors could probably suffice as the nuts and bolts of an explanation of policy fiascos. Even if we assumed a perfect hierarchy of institutional actors with, for example, the core executive represented by the prime minister and the minister of finance as heads of policy, the limitations specified here should suffice. It would be enough to explain an inability to co-ordinate change among functionally interdependent policies. Still, there is a need to consider the inter-individual, or more to the point, inter-institutional level as well.

reality then, Mjøset, Nelson and Winter and this work have a common root since most of the theory of action related thinking I draw on here is can be traced back to the Carnegie tradition.

³⁷ Pure rationality on the individual level can be defined as knowing all the alternative courses of action, their consequences and that all preferences relevant to the choice are known, precise consistent and stable (March 1994:4). In general this section draws heavily on March (1994), although my practice of treating this author’s insightful and nuanced discussions as a Chinese menu of concepts makes me hesitate in implicating him or anyone else in this discussion.

An assumption of a polity made up of unitary and perfectly co-ordinated institutional actors will not do for the purposes of this analysis. The most interesting observation in this regard is a lack of co-ordination between different policies in the care of the same institutional actor, and in some cases a pattern of distinct and conflicting goals between separate institutional actors. Conflicting “local” goals can in principle be understood within a rational choice framework, but it is difficult to see the analytical utility of reintroducing heroic rationality assumptions in the middle of the discussion. It would also narrow the scope of possible interpretations of some of my observations. For instance, the suspicion that the central bank was not always protesting very loudly against incomplete reforms because it was playing for higher stakes. The argument would go along the following lines: At one point the central bank got so frustrated with the performance of its available repertoire of routines that it started thinking strategically. If this is correct the reason why the central bank chose this line of action is that it reckoned that in a democratic system, one step at the time was better than no “progress” at all. If this sort of calculation was indeed made, the rationality of it can be questioned. It seems that the costs of pursuing the chosen strategy were greatly underestimated.

While on the subject of inter-institutional dynamics, it can also be noted that division of labour among state agencies with differing competencies and expertise can contribute to increasing problems of sequential attention and misguided decomposition. Partial insights embedded in the local rationalities of the individual institutions run the risk of being lost rather than aggregated as institutions clash over how to interpret and handle given situations. This concludes the present discussion of micro-foundations. All of the themes introduced here will, however, reappear in the subsequent analysis. Not least in the next section, which seeks to develop and embed in theory the notion of disparate policy paths.

2.2 Disparate policy paths as sources of co-ordination failure

Freeman (1995:20) concludes what he himself calls his speculations on the relationship between tightly coupled systems and costs of change by arguing for what

is otherwise known as “shock-therapy”. For tightly coupled systems “long jump adaptations” that is “changes in several components at once” are probably preferable to local adaptation, according to Freeman. He further notes that this might “be impossible to bring about except for in a politician’s promise.” Historical evidence indicates that he is right on first issue (impossible to bring about), although the same evidence hardly allows us to draw any conclusions on the last.³⁸ What remains, however, is that uncoordinated change of the type that opens up blatant inconsistencies in the policy mix is costly, and a valid question is then, why does this kind of situation arise? Or put differently, why are even semi-long jumps – i.e. simultaneous reforms of a handful of key institutionalised policies - so difficult to achieve?

This section addresses this problem through the concept of disparate policy paths. To get a handle on a highly complex discussion involving as much as 11 different policy areas, my prime organising device is as stated above, to let the analysis revolve around the lifting of credit controls. Drawing on how the functional interdependencies of the SDCM was fleshed out in subsection 2.2.2 above, I proceed from the premise that the scaling down of credit controls and the subsequent credit explosion represented a fundamental functional challenge to routinised policy making in other policy areas. This points towards concrete questions such as: The markets for shares and housing were lifted before credit controls were lifted, why was this so easy to achieve? And why was it much more difficult to lift interest rate controls and reform the tax system, even after a credit boom clearly provided a strong functional argument for doing this? Or, why did both public bodies and banks alike systematically underestimate the risk involved in a liberal credit market?

For our purposes here, theories of institutional change can be grouped into two. One school of thought tends to rely on the idea that institutional change is fast if not instantaneous, and well matched to the environment. This is the kind of thinking that

³⁸ Some might object to letting the buck for marketing such ideas stop with politicians. In debates over reform of the economic institutions of post communist states, influential economists like Jeffrey Sachs (1994) and Anders Åslund (1993) have been known to argue a similar position: Long jumps or “shock therapy” as it has been called in the post-communist context, is achievable and should be attempted. See Gowan (1998) for a critical discussion of the history and merits of shock therapy.

animates theories of natural selection and rational choice. The alternative is the inverse, that change can be slow, constantly lagging the environment or not forthcoming, and that if it arrives it may very well be maladapted in relation to changes in the environment. In the language of March and Olsen (1996:256) some theories are built around the notion that history is efficient. They themselves advocate a brand of institutionalism that holds that history is inefficient in the sense that:

There is no guarantee that the development of identities and institutions will instantaneously reflect functional imperatives or demands for change. Political institutions and identities develop in a world of multiple viable possibilities. Moreover the paths they follow seem determined in part by internal dynamics only loosely connected to changes in their environments.

We see that the two schools of thought depart from each other along two analytically distinguishable dimensions. The first is the pace of change the other is degree of maladjustment. In empirical investigation this is not a clear distinction. Lack of ability to keep pace with changes in the environment will by definition inevitably lead to maladjustment. As an organising device for my discussion of the sources of disparate policy paths, however, this distinction can be helpful: The first source of disparate paths - asymmetrical degrees of stickiness - can by and large be framed as a problem of pace versus inertia. The second and third sources of disparate policy paths - selective learning and imported dynamics - on the other hand, revolve more around maladjustment. Maladjustment because inertia is not necessarily the problem, although it can play a part. Of more importance is the active choice of new strategies that match the functional requirements of the environment badly.

My scheme is to theorise the dynamics of the different policy areas under study here by applying insights from the discussion of the sources of disparate paths. Different policies' relationship to the politics and policy of credit controls will be subsumed under the different headings. The fit is not one to one. In a few cases, I need to draw on insights from more than one discussion of disparate policy paths to be able to give a better account of the policy in question. The general pattern looks like this. I will seek to develop an understanding of the dynamics of five of the 11 policy areas under investigation in this analysis in light of the theory mobilised under the heading of asymmetrical degrees of stickiness. (Share and property market regulation, capital

and interest rate controls and tax policy). The negligence of policies relating to risk management (capital adequacy standards, loan-loss regulation and the priority given to supervision in general) will we be interpreted under the heading of selective learning. Under the heading of imported dynamics capital controls and exchange rate policy, both of which were fundamentally influenced by europeanisation, will be accounted for. This leaves two policy areas - fiscal and incomes policy -, which I will treat as exogenous factors. That is I will bring them in because other policies were not accommodated to them, but I will not seek to theorise the dynamics of the policy making of these policies in their own right.

2.2.1 Asymmetrical degrees of stickiness

The notion of asymmetrical degrees of stickiness implies appreciating that there may be some truth to both the above mentioned perspectives on institutional change. In other words, one can start out from the banal proposition that sometimes desired or functional change is relatively easy to achieve, sometimes it is not. This is so because different policy areas are subject to different kinds of dynamics. As indicated above, in addition to the politics of credit controls, the groundwork for theorising two other clusters of policies will be laid in this subsection. Firstly, we have share and property market regulation which were liberalised before credit controls were lifted, (which in turn stimulated a process of asset price inflation when credit became easier to obtain). Secondly, there is a need to investigate why interest rate controls and tax breaks were not done away with simultaneously so that price policy in the credit market could have been co-ordinated with the policy on volume.

In order to theorise asymmetrical degrees of stickiness it is useful to go back to two fundamental questions in political science: Who are the key actors in political processes and what is the relationship between politics –as a process - and policy as content? The default mode of political science analysis is pluralism or what is also called interest based explanations.³⁹ It is the kind of explanatory perspective which

³⁹ The classic pluralist text is that of Dahl (1961). Lindblom (1977) is another important “older” text. Among the pluralist or interest based contributions that address economic policy more

proponents of other perspectives invariably relate their efforts to. Therefore a discussion of basic questions like the two above can benefit from taking a pluralist point of departure.

2.2.1.1 Pluralist versus statist theories

What, then, are the basic assumptions of pluralism as regards actors and the games they play? The short answer is that the key actors are groups formed on the basis of positions vis-à-vis social cleavages that engage in coercion, exchange and/or persuasion in order to promote their interest at the expense of rival interests. Thus in democratic/pluralist polities the politics of societal interest articulation and aggregation determine policy.

The transmission belt running from interests generated by individual positions on societal level cleavages to state-decision making apparatus can be electoral politics or organised group-interest mediation. The transmission belt or process issue is, however, less important than the conviction that policy outcomes can be reconstructed as the triumph of one societal interest over another. Such victories reflect political resources of which numerical strength measured by support at elections is the most straightforward. Sources of strength in extra-parliamentary channels are typically more difficult to measure independently from the outcomes which we try to explain with reference to this strength. This also represents a trap for pluralist analysis. The temptation is to equate explanation with the (apparent deductive) identification of changed interests and or power resources consistent with the observed outcome, without attempting to reconstruct the process whereby one interest came to triumph over another.

That pluralist analysis can be more or less inclined towards process tracing is not a point of great principal interest. More important is the fundamental similarity shared by all pluralist approaches in that they see changing interests and/or coalitional patterns brought about by societal change and/or changing actor strategies as the way

directly are Shalev 1983, Cameron 1984, Esping Andersen and Korpi 1984, Esping Andersen 1985, Garret and Lange 1991 and Garret 1998.

to explain policy change. They are what March and Olsen (1989:3) call “contextual”, in that they are

...inclined to see politics as an integral part of society, less inclined to differentiate the polity from the rest of society.

The obvious alternative to this is to view politics as a more separate activity. One powerful expression of such a view is to found in a tradition that we with Krasner (1984) can refer to as statist.⁴⁰ In this view the state (whether seen in Marxist terms as a ruling class or in more neutral terms as a government with an obligation to lead) has a significant degree of autonomy from civil society. The chain of influence running from interested individuals via organised groups to policy making and implementation is broken at one or several points, or it can run the other way. Another important premise is the fact that politics is about more than distributive struggles. It is also about common problems, and as international relations scholars in particular can remind us, about “us versus them”.

The state is thus more than a reflection of the society it serves. The state can be an actor in its own right. It can shape society and define the cleavages and the rules of the game according to which battles over rival interests are fought. This perspective can be given a more or less pessimistic reading. The worst case scenario is one of corruption. Where the political class in it self constitutes an interested group, which primarily uses its political power to serve its own material interests.⁴¹ Statism, can also, however, be given a more optimistic reading. A reading where autonomy is used to try

⁴⁰ Peter Hall (1993:276) distinguishes between two strands in state-theorising, state-centric and state-structural. While the first focuses state autonomy the second is somewhat closer to the pluralist tradition in that it emphasises the interplay between state-structure and policy legacies on the one hand and the force and nature of societal demands on the other. I have not used this vocabulary here, but in broad lines the argument I develop below could probably be described as moving from a state-centric stance to a state-structural position. It is my impression that two contributions in particular stand out if we want to understand the renewed interest among non-Marxists in theorising the state that occurred in the mid-eighties. In 1984 Krasner’s article “Approaches to the State: Alternative Conceptions and Historical Dynamics” which also introduced the “punctuated equilibrium metaphor appeared. Then one year later there was an edited volume by Evans et al. “Bringing the State Back in. In particular the introductory essay by Skocpol is often quoted. An earlier work that can be seen as something of a bridge between earlier Marxist attempts at conceptualising the state and later non-Marxist work is Nordlinger (1981).

⁴¹ At this point pessimistic statism becomes almost indistinguishable from some types of pessimistic pluralism.

and overcome the parochial and short time horizons often found in struggles between groups defined by material interests. A middle ground between these positions can be defined as the view that sometimes in some issues technocratic forces take the lead as they seek to solve problems that are perceived to be common. This point is worth elaborating. The notion that technocrats – or government economists to be more specific - can wield political power is a recurring one in this thesis.

If we accept that the advice given by government economists can have significant bearing on policy, the question of what drives them, what kind of interest do they represent, becomes interesting. The tradition that studies bureaucracies from the point of view of individual incentives perceives the interests of bureaucrats as narrow and material. This tradition assumes that individual bureaucrats seek programme and unit expansion in order to maximise their career opportunities, salaries and prestige (Niskanen 1971). Likewise, in theorising on the professions a distinction has been drawn between a “naïve” and a “cynical” tradition. Much like Niskanen’s theory, the cynical view is that professions primarily aim for monopoly and closure because they are driven by a desire to enhance the power and income of its members. The naive view - which Brante associates with Parsonian sociology - links professional advice to enlightenment ideals and rational progress based on scientific knowledge and consisting of “altruistic members of which are filled with a desire to work for the common good”(Brante 1988: 122).

The way Brante puts the issue, the alternative to cynicism does indeed sound naïve. This opposition may be misleading however. We can understand profession-building at the macro level primarily as a boundary drawing exercise (Abbot 1988) and we can refute the more naïve understanding of progress inherent in the Parsonian view. At the same time we can still see professional training as instilling an overarching sense of purpose and a method for achieving these standards in the members of a profession. Further, we can expect that institutions also have has a profound effect on the identities of its members. In institutions dominated by one profession, as is the case with economists in central banks, professional standards and institutionally defined logics of appropriateness can sit fairly easily together, in stable periods they blend into

each other. To be specific: It is my contention that job satisfaction in central bankers is linked to their ability to managing the monetary economy in accordance with their institutionally inherited ideals. At the same time their economist training supplies the analytical tools for working out how this management can best be achieved.

It should be noted that this desire to do a good job is compatible with more narrow career wishes. To achieve such compatibility the organisation needs its values and standards to be widely shared through its hierarchy. It is important to note that these standards are neither arbitrary nor mere reflections of the interests of dominant societal forces. An essential part of the story told in this thesis, is about how institutionally defined goals (to manage the domestic monetary system in an orderly manner) interacted with (a changing) understanding of means-ends relationships in the economy. Both the initial (“Oslo-school”) and the new (neo-liberal) understanding of means-ends relationships was in turn fundamentally influenced by the central bankers training into and membership of the economics profession.⁴²

This is no guarantee, however, that some interests are not served better than others by the policies that result from such processes. Policies designed on technocratic premises will normally also have distributive effects. The point is that policies can have well-meaning technocratic fathers, even in cases where we can identify clear distributional effects.

2.2.1.2 Actors and policy content

How, then, can we formulate expectations about when technocracies will have a strong influence, and when policy will be dominated by societal forces? For this we need to go back to the relationship between politics and policies. The standard mode of analysis is the pluralist. It assumes that a process (politics) gives rise to an outcome (policy). If we look closer at this approach, however, we see that even in its most basic

⁴² An alternative hypothesis is of course that most of the central bankers that wanted to do away with the Norwegian regime of low interest rates wanted this because they were at a stage in their life cycle where they were moving towards becoming net creditors. At this juncture it is tempting to be polemic. If it is naïve to assume that government economists are motivated by a genuine desire to do a good job (as defined by professional and institutional standards), it is close to paranoid to assume that all that drives them is considerations for their personal purse.

form it actually, if often implicitly, has to posit a two-way relationship between process and outcome. In the case of a leading pluralist like Dahl (1961) expectations about outcomes is fed into the process, by way of influencing who will participate: Any given arena is populated by the societal groups that are assumed to have a stake in that particular issue. Other parties stay away. This means that also for pluralists policy, substantively defined, shapes politics, defined as who participates. For Dahl this was a key point when defending the legitimacy of the system he claimed to observe at work.⁴³ It is probably fair to say that this normative premise has received less attention in later pluralist analysis. In more recent work it seems that the insight that participation is issue-area specific is taken for granted, it is not treated as a potential variable. It is just a starting point for the “real” exercise, which is to explain political outcomes by reference to changed power relationships and/or interests.

Lowi (1964, 1969) took issue with most of Dahl’s conclusions. Of greatest interest here is his effort to replace the great pluralist’s descriptive categories with a more abstract approach, so that a typology of policies could be established. He did this by distinguishing between policies according to in what way (issue specific) interests were touched, and juxtaposed, by them.⁴⁴ Two implications of Lowi’s agenda are of particular importance for the present topic. Firstly, he replaced the dichotomous notion of interested or not, with a concept of degree of interest. This approach makes it easier to establish expectations of group interest that is reactive, piecemeal and even periodically ignorant to its representation within an issue area. Secondly, we become more sensitive to the possibility that there are policies that lack a (societal) constituency. Such policies must by necessity be driven by other actors than those

⁴³ Another optimistic notion was that of pluralism as a highly competitive system. There are many organisations, the organisational landscape is fluid, individuals have a real choice which in turn guarantees them real influence vis-à-vis full time leaders and staff of organisations. Lindblom was less optimistic than Dahl on this score, tending as he was to emphasise the power of vested business interests, see Krasner (1984:226).

⁴⁴ He invoked dimensions such as to what degree financing and production of a political good were “visibly” coupled and to what degree the political goods dispersed were dividable. Still, one can probably say that as far as the issue of policy typologies is concerned, Lowi’s achievement lay more in being evocative than in being clear. The agenda he opened is of more interest than the finer points of his argument.

focused on by the pluralists. The prime candidate for the role of alternative actor is the state apparatus in some shape or form.

Lowi's work inspired other policy typologies. One that has proved to possess considerable staying power, and which is of deep relevance to the present study, is a simple two-by-two matrix set up by Wilson (1973). Wilson generates four types of policy by combining the dimension diffuse/concentrated with the dimension costs/benefits. Wilson's key point is that policies that give rise to either concentrated benefits or costs are easier to mobilise societal actors around. This entails that policies giving rise to both diffuse costs and benefits are likely to lack an interested societal constituency. An overarching system like the Social Democratic Credit Model can be seen in this light. Interest rates changes are spread out thinly over the whole economy. This gives rise to thin or diffuse preferences, which predicts low societal involvement in the issue area. Secondly, in periods when even this structure allows for strong political motivation (as in periods when a ruthless hard currency approach is pursued) such initiatives could be impeded by collective action problems. Successful influence in monetary policy tends to create a good that is both non-dividable and non-excludable in consumption (Gowa 1988).

To this one might add Krasner's (1978) point that policies that are perceived as complex, and the tools of credit policy were indeed complex, are more likely to be dominated by experts. This has a positive explanation: complexity creates a demand for expert interpretation. It also reminds us that, unlike the pluralist assumption, all policies are not framed in distributional terms. Expert influence will be more legitimate if problems are defined as common. Hecló (1974:305) captures this beautifully in the concluding chapter to his often-quoted book on social policy in Britain and Sweden:

Politics finds its sources not only in power but also in uncertainty – men collectively wondering what to do. Finding feasible courses of action includes, but is more than, locating which ways the vectors of political pressure are pushing... Policy-making is a form of collective puzzlement on society's behalf, it entails both deciding and knowing... This process is political, not because all policy is a by-product of power and conflict but because some men have undertaken to act in the name of others.

Expert influence in complex issues also has a negative explanation: complexity makes it harder for societal interests to work out what is at stake when reform of a

given policy is suggested. The more precise effects of and even the general logic behind - not to say the difference between - primary, secondary and supplementary reserve requirements is not among the easiest of topics to get on top of. And even when individual actors possess the insight necessary to clarify the effects of a given credit market model, it can be difficult to establish which interest is the strongest. This is because the effects of credit market regulation work through many routes. All individuals and most organisations have multiple roles that can be affected differently. Two examples can illustrate this point. Are exporters interested in a tight use of credit controls because it helps keep inflation in check, or do they as producers want more liberal access to credit in order to invest? Or, is my household supportive of tighter credit controls because it keeps interest rates down, or are we as public sector employees interested in a credit policy that puts less pressure on fiscal policy?⁴⁵ Or finally do we accept higher interest rates as the price we have to pay to get more immediate access to more credit?

Even banking interests can be hard to determine a priori. For example: Are banks within a regime based on interest rate and credit controls interested in maintaining the cartel dynamics this facilitates, or do they want freedom to expand? And if one accepts Gowa's point that collective action problems can be a disincentive to engage in lobbying over credit policy at the systemic level, it follows that this argument might also apply to banks.

The policy determines politics literature has been accused of being too static. This would be the case if one assumed that for each policy a given set of propensities gives rise to a particular mode of participation, all through the policy cycle. Such an approach would not be advisable for this project. Here – compared to most of the policy determines politics literature - attention is broadly speaking moved from the earlier stages of the policy cycle (research and policy formulation) to later stages (decision making and implementation). This makes it necessary to bring societal interests back into the analysis, even in issue areas where one could correctly

⁴⁵ The functional relationship between credit controls and fiscal policy was explained in subsection 2.1.2 above.

hypothesise that societal actors were not active in formulating demands for reform. Stickiness implies that there is a counter-force to technocratic reform drives. And within issue areas where societal interests played a largely passive role when plans for reform were being formulated, it is still possible for them to mobilise opposition and/or support when the reform issue has been established as an item on the political agenda.

Finally, a focus on implementation makes it necessary to disaggregate the concept of credit policy. Even though the technocrats argued for them as two sides of the same coin - the liberalisation of credit controls was temporally separated from the liberalisation of interest rate controls in the implementation process. I seek to understand the dynamics of five issue areas under the heading of asymmetrical degrees of stickiness. What then, can the “policy determines politics” body of thought tell us about the chances that a given policy can easily be reformed or not? In order to answer this question we need to consider not only the structure of interests, we also have to link interests to organisations and to the cognitive processes that shape (perceptions of) interest. Paul Pierson (1996) has implicitly made this sort of application in an essay of broad relevance for the present study.

Pierson has been interested in understanding why welfare state cut-backs have been so difficult to achieve after the widely acknowledged crisis of the welfare state set in, in the late 1970s. He makes this puzzle even more intriguing since a lot of his case material is from countries where hugely popular conservative politicians - prime minister Thatcher in the UK and president Reagan in the USA - expressed a clear preference for this type of policy.

Pierson’s main argument concerns how interests are touched by reform proposals. For this purpose he draws selectively on Wilson’s typology. Pierson acknowledges that it has become a standard proposition in political science to hold that concentrated interests are in a stronger political position than diffuse ones. Therefore reform proposals that give rise to concentrated costs and diffuse benefits (like cutting in concrete welfare programmes in order to improve public finances) are likely to meet strong societal resistance. At this point Pierson expands his argument by adding organisational and cognitive factors as mentioned above. I will return to these

arguments, but my aim of comparing across issue areas provides a reason to stay with Wilson for one more quadrant. Namely, the inverse of the one above, which is filled with policies that give rise to concentrated benefits and diffuse costs. The hypothesis would be that reform proposals with these characteristics would be relatively easy to push through.

On its own, how interests are structured is not enough to provide a satisfactory account of political influence. Somehow interests must be represented and more often than not they are mediated through organisations of some permanence. A key point here is that the structure of interests and organisational structures are likely to be correlated. In a rationalistic perspective, to organise is not much more than to undertake a long-term investment in pursuing a stable and durable set of interests. And as Pierson (1996:145) argues, concentrated interests increases the likelihood that individuals will find it worth their while to engage in collective action. Further Pierson notes that organisations are also important as providers of information on policies that may affect the interests of its members. To this we may add that in a more constructivist perspective they can also be expected to fundamentally shape their members conceptions of what their interests are. Still, the presence of organisations cannot be taken for granted. When we reason from a notion of interests deduced by the analyst, the presence/non presence of organisations representing them must remain an open, empirical question.

It is also important to note that Pierson, like many others writing about interests, adds the adjectives tangible and uncertain (and thereby implicitly intangible and certain) to the established dichotomy between concentrated/diffuse. This is done without any serious conceptual reflection. Apparently the meaning of these concepts and the relationship between them is held to be self-evident. Maybe this is because in social policy conducted along non-universalistic principles (i.e. the majority of all social policies) the three sets of qualities will often be confluent. A welfare entitlement paid out in cash, or provided as a service to a specific group is both concentrated, tangible and certain. The alternative, better public finances, is in principle diffused over the whole economy and it is uncertain for any given group whether there are any

tangible gains to be reaped from cost-cutting in a specific sector. It is, however, quite possible for a political good to be diffusely distributed but tangible and certain at the same time. This is the case with many welfare goods distributed according to universalistic principles. Norwegian child-benefit is a case in point. It is paid out to all parents, irrespective of their means, for all children until the offspring is 18 years old.

Admittedly, concepts like tangible and certain are hard to define in ways that lend itself to clear operationalisation. Still, its use in the literature on interests alludes to an age old insight that people value more what they can touch (and see) given the choice between that and what they cannot, partly because what they can touch is perceived as more certain. This insight is expressed in a proverb like the Norwegian “*det er bedre med én fugl i hånden enn ti på taket* - one bird in the hand it is better than ten birds on the rooftop”. What is expressed here is a kind of pessimism. Tangibility and the certainty it is held to bring, are preferred even at the cost of forgoing potentially greater rewards. This sort of reasoning moves us towards a cognitive level of analysis. One literature that allows us to make the full step into psychology and theorise this phenomenon is prospect theory (Kahneman and Tversky 1979).⁴⁶

This theory of decision- making under risk (underscored by several experiments) claims that people in general have an aversion against suffering losses. To avoid a loss is valued higher than to achieve a corresponding gain. The theory goes so far as to predict risk seeking behaviour when avoiding a loss is at stake, while it predicts risk aversion in the face of potential gains (March 1991:28, Nyhamar 1998:281-282). Pierson (1996:146) refers to studies of voting behaviour which has applied these insights and argues that “negativity bias” provides an additional mechanism that can help us understand why welfare reforms have been hard to achieve. In the context of asymmetrical degrees of stickiness we can thus hypothesise that voters react more negatively to reforms that carry the prospect of losses than they react positively to corresponding gains. For purposes of this analysis it is important to

⁴⁶ The theory was introduced in the 1979 article. Later the original authors (sometimes in collaboration with others) have refined it. For a mini-review see Nyhamar (1998).

note that this mechanism can be politically significant even when the losses are widely distributed and in the absence of specialised interest organisations. This can be the case if party politicians sense this loss-aversion and act upon it.

A criticism which has been directed against prospect theory is that it is difficult to establish the reference point which help us draw a line between what constitutes a foregone gain and what constitutes a loss (Nyhamar 1998:286-288). The claim is that outside the social psychology laboratory the analyst can be tempted to define the reference point so that the outcome will fit the prediction. Subjective reference points, which this ultimately boils down to, are of course inaccessible to the analyst. My strategy for handling the problem of reference points will be to try and be as clear as possible when discussing potential outcomes from the reform efforts analysed here. That is, I will seek to distinguish between the political goods that are distributed as the result of a present policy, and what kind of goods are potentially in the offing as the result of a reform. The former type of goods should then have the ability to release loss-aversion, while the latter should not.

2.2.1.3 Political stickiness – six propositions

We can summarise this attempt to theorise asymmetrical degrees of stickiness in the following six propositions:

- 1) Policies that give rise to diffuse costs and concentrated benefits have a greater chance of being supported by societal forces and less chance of being opposed and are therefore likely to make the journey through the policy cycle relatively fast.
- 2) Policies that give rise to concentrated costs and diffuse benefits are likely to be opposed by societal interests and they will therefore be delayed after conception and before implementation is achieved.
- 3) Policies that give rise to concentrated costs or concentrated benefits are more likely to have specialised organisations catering to these interests than policies that give rise to diffuse costs and benefits. The presence of such organisations can help delay/speed up the journey through the policy cycle

of policies that run counter to/serve interests that are structured in a concentrated manner.

- 4) Policies that give rise to diffuse costs and diffuse benefits are likely to be dominated by experts.
- 5) Complex policies, which make it difficult for ordinary citizens to calculate what is at stake for them, are also likely to be dominated by experts.
- 6) Voters value maintaining established (and tangible and certain) politically distributed goods higher than the prospect of achieving new goods of a corresponding value. Party politicians can sense and act upon this. This is a mechanism that can produce delays in implementation, even in the absence of concentrated costs and specialised organisations.

These propositions are complementary rather than competing. They cover different types of interest structures and where they cover the same (e.g. the relationship between propositions one and two on the one hand and proposition three on the other) the logic is additive. The only point at which potentially rival expectations is generated is between proposition six on the one hand and propositions one and four on the other. This is because proposition six implies that tangibility and negativity bias together may create enough stickiness to cancel out the expected effect on implementation of a policy giving rise to diffuse costs.

2.2.2 Selective learning

The term selective learning is meant to cover situations where there is ignorance about, or insufficient understanding of, functional interdependencies between issue areas. This leads to neglect of important problems in processes of regulatory reform. The key word at this juncture is selective. Building on Hall (1993:277) we can define policy learning as the ability to interpret the character and effects of policy at time₀ so that it has implications for how policy is created at time₁. Thus, learning involves drawing causal inferences from one's own or others' past experience. Causal inference

about the effects of policy requires prior conceptualisation of key attributes of policy. Applying causal propositions to future policy involves comparison. Conceptualisation and comparison require abstraction, an ability to distinguish relevant similarities between then and now, and us and them. Abstraction involves choice: some aspects of the cases analysed are ignored others are focussed on. In economic policy making, economic theory is instrumental in achieving such abstraction. In planned reform processes preceded by technocratic research, the accepted procedure is to use economic theory in an explicit manner. This makes it easier to see how abstraction entails ignoring some aspects of cases altogether, how some aspects are seen but are deemed causally irrelevant for the problems in question, while yet other aspects are ascribed causal roles in the processes the planners deem it desirable to manipulate.

In the above sense all (policy) learning is selective, so strictly speaking the concept of selective learning is a pleonasm. But I emphasise the selective nature of learning for a reason. I want to signal a focus on those biases of the learning process that increase the likelihood that planners and decision-makers will be ignorant about the nature of key functional interdependencies. History is always ambiguous and biases structure our choices when interpreting it. Ignorance about interdependencies is important because it produces oversights regarding the need for mutually accommodated adjustments of policies. What first motivated this study was the following perception: That there was a fundamental asymmetry in the way the technocrats working with credit market regulation treated the cognitive framework they were abandoning (“Oslo school”) and the one they were taking up (Neo-liberalism). “Oslo school” economics were subjected to a rigorous critical discussion apt to reveal most of the problems a governance mode based on its principles were likely to produce. At the same time the tenets of neo-liberalism were given a much more generous treatment. Neo-liberal governance principles were only viewed as a solution to pre-existing problems. Principles of critical analysis were not so willingly employed at this end. No attempt was made to reveal the potential of neo-liberal economics for producing its own set of problems of governance. The key task in this

section is to try and gain a deeper understanding of how such an asymmetry can come about. I will do this by linking it to biases inherent to the learning process.

My method for studying selective learning is predominantly inductive. It entails benefiting from hindsight as one moves backward from a set of undesired outcomes via the oversights that helped produce them. This is done in an attempt to uncover systematic biases in technocratic learning. I will not formulate testable hypotheses or even propositions, as I did when discussing asymmetrical degrees of stickiness. In this chapter I will limit myself to a fairly brief discussion about what an eclectic mix of theoretical strands can lead us to expect from learning processes like the one under study here. I will distinguish between biases at two levels of abstraction. At the highest level of abstraction we can apply theories that can help identify biases that characterise learning processes in technocratic environments in general. At a more concrete level we can also speak of biases rooted in the nature of economic knowledge production in Norway in the late 1970s and early 1980s, and in neo-liberal theory as it stood at that point in time.

2.2.2.1 General technocratic biases

Within the most general category we can distinguish between two different sources of bias, both consistent with the lack of willingness on the part of the technocrats to critically examine neo-liberal policy advice. Firstly, and most fundamentally, bias originates in how technocrats allocate their attention, particularly critical attention. Secondly bias can stem from or at least be reinforced by the need of technocrats to be able to sell the results of their knowledge production to politicians.⁴⁷

⁴⁷ At this point it is tempting to list a third source of bias, namely the pressure to conform to norms transmitted from institutionalised environments. This kind of expectation could be generated from reading the “sociological” variant of neo-institutional organisation theory for our purposes (confer Powell and DiMaggio 1991). This perspective is clearly relevant to a discussion of selective learning because it highlights the importance of external legitimisation, and that such legitimisation can substitute for learning through critical reflection e.g. the notion of mimetic behaviour. I have chosen, however, to reserve my discussion of external legitimisation and the influence of centres of professional authority like the OECD, IMF and the bigger industrialised nations to the sections of this thesis that deal with imported dynamics. This is an editorial choice. I have no particular analytical motivation for choosing one solution over the other.

The allocation of critical attention is a complicated topic that is more or less explicitly dealt with in many literatures such as cognitive psychology, organisation theory, decision-making theory and the sociology of science. Within the literatures I have relied on throughout this analysis one can, however, identify a core idea that is held across different traditions. This is the standard institutionalist supposition of privileging inertia. In the context of learning, this idea can be specified as the expectation that critical analysis of routines and axioms is not an everyday activity of people engaged in decision-making and research. Instead such activities need to be triggered by a significant gap between actual results and desired outcomes (goals). As indicated in the subsection on micro-foundations, this is in line with expectations one can generate by viewing the theory of satisficing as a theory of attention and search (March 1994:27-29). Any exact meaning of the term significant gap is of course impossible to give except maybe post-hoc. Still, the term implies that there is a threshold to pass before critical attention is mobilised. Problems have to be experienced and they have to be considered big or important. This threshold exists, not just because attention is a scarce resource, but because people don't like challenges to what they take for granted. One term for this is belief conservation. March (1994:183) points out that a vast body of studies of human interpretation indicates that this is a very real phenomenon: decision-makers tend to interpret new experiences and information in ways that make them consistent with prior beliefs.

At this stage we can draw on the sociology of science of Kuhn. In an earlier analysis that applied a "Kuhnian" perspective to the demise of the Social Democratic Model, I formulated an expectation that was borne out by the subsequent historical reconstruction. This was that a shift in the cognitive framework of technocrats only would occur after problems of governance have been sought solved within the limits of the old cognitive framework (Tranøy 1994b). Kuhn's theory can therefore be seen as a more specified theory of the allocation of critical attention since it distinguishes between a moderate level of critical attention and a more radical level (or revolutionary - to keep in line with Kuhn's terminology). Thus Kuhn's model of change and continuity can be subsumed under the punctuated equilibrium metaphor. This is a theory of long

periods of relative stability punctuated by revolutions.⁴⁸ In my previous work the ambition was to explain change in credit policy advice, thus I was primarily interested in the revolutionary or change aspect of Kuhn's theory. In the present work I am primarily interested in the quality of the advice given. Given this interest it is more natural to focus on the stability aspect.

When the search for answers is restricted to the existing paradigm, Kuhn speaks of "puzzle-solving", which he held to be the key activity of "normal science". This terminology enables us to extend the parallel to the concept of belief conservation as defined by March. Because according to Kuhn, puzzle solving implies that theories are not being put to test. Axioms are not being critically examined. In stead it is the scientist who is being tested, in his ability to "achieve the anticipated in a new way" (Kuhn 1962:36).⁴⁹ Kuhn's views were, of course, to a large degree intended to be a descriptive and realistic antidote to Popper's normative ideal of science. Popper's norm was for science to be a free and highly critical form of inquiry. This is encapsulated in the notion of scientists engaged in the production of brave, new hypotheses, followed by rigorous attempts at falsification (Popper 1959).

It is my contention, however, that if a phenomenon like belief conservation can have an important role in proceedings within the scientific community – which has explicit ideals to the contrary – it is not unlikely that this phenomenon can actually dominate knowledge production within technocracies. This is the case because in technocratic settings ideals of free inquiry must be assumed to be weaker than they are in overtly scientific settings. In sum, if both belief conservation and a focus on experienced problems limit critical attention, we can expect two effects. The first is

⁴⁸ Kuhn – like Krasner also does – makes it clear that to think of change in this manner has deep and diverse roots. But while Krasner, a political scientist, turned to biology for inspiration, Kuhn who was trained a physicists acknowledges his debt to the Humanities. In a postscript to the 1969 version of his work on the structure on scientific revolutions he makes the following statement. "To the extent that the book portrays scientific development as a succession of tradition-bound periods punctuated by non-cumulative breaks its theses are undoubtedly of wide applicability. But they should be, for they are borrowed from other fields. Historians of literature, of music, of the arts, of political development and many other human activities have long described their activities the same way (Kuhn 1962:208).

that after neo-liberalism was established as the dominant cognitive framework for credit market analysis its axioms could not be critically examined. They would only be applied to puzzles generated by policy. The second is a bias against seeing causal links that have so far had benign effects.

But what if we, for the sake of argument, assume that technocratic researchers could successfully resist both the impulse of addressing only present problems and the impulse of belief conservation. What could happen if the technocracy subjected the axioms of neo-liberal credit market regulation to critical examination? In such a scenario one can still expect there to be a bias towards not communicating whatever doubts such an exercise might produce. The notion that expert advice is more easily heeded if presented as positive and unanimous is a central tenet of the “politics of ideas” and “epistemic communities” literature (Hall 1989, Haas 1992). The mechanism behind this bias is obvious and should require little elaboration. If experts deliver a split “verdict” opposing societal interests can seize on the analysis which best serves their interest, and experts risk being reduced to the role of water-carriers. If advice is unanimous and basically uncontested (preferably also by neighbouring research communities), it can take authority from its scientific basis, a value that commands respect in complex and rationalistic societies. Experienced technocrats understand this and strive to present a consensual front, given that it is their desire to get something done about a particular problem.

2.2.2.2 Biases in economic knowledge production

After having considered the level of technocratic learning processes in general, we can move on to biases embedded in the character of economic knowledge production. The chief source of oversights at this level is the dominant position of comparative statics as analytical procedure and with parsimony the key criterion for evaluating theory formulation. There is a strong preference for powerful abstraction, avoiding the “messiness” of analysis embedded in the peculiarities of time and space.

⁴⁹ On the same page Kuhn offers this definition: Puzzles are...that special category of problems that can serve to test ingenuity or skill in solution (Popper 1962:36).

Neo-liberal advocates of liberalisation want to exploit behavioural change brought on by institutional change. But they operate on very limiting assumptions which in effect abstract away the process of change itself. Actors are expected to adapt to institutional change instantaneously and rationally, moving the market from one stable and stylised equilibrium to the next. The most obvious example is when liberalisation is justified with reference to the expectation that this will induce more efficient behaviour on the part of the market actors. This is expected to be a lasting beneficial consequence of changing the rules of the game towards a more competitive market. It is not my claim that these characteristics of knowledge production dominate all work by professional economists at all times. But I do claim that the picture drawn here captures the essentials of mainstream and technocratically relevant Norwegian economist knowledge production and analysis before and during liberalisation.

If one accepts the diagnosis above, it is possible to make this a point of departure when trying to specify the biases that flow from the character of knowledge production. One bias that comparative statics analysis founded on rational and instantaneous adaptation tends to create, is the obfuscation of the fact that learning takes time: institutional change can be followed by a period of fumbling or maladapted behavioural change. What historical evidence brings out is that liberalisation is not a simple retreat operation releasing pre-existing or spontaneous markets to blossom. To the contrary, liberalisation places strong new and different demands on both the state as regulator - it gives rise to reregulation (Cerny 1993, Vogel 1996) - and on the learning capacity of market actors with little relevant behavioural experience (Engwall 1997).

Further, one can claim that the preoccupation with rational behaviour creates a bias against expecting irrational speculation and the ability of market actors to assume unreasonable risk. The leading light of neo-liberal thought, Milton Friedman (1953) for example, combines rational choice and natural selection reasoning in his famous claim that there cannot be destabilising speculation in the long run. According to Friedman, speculators are people who buy when prices are low and sell when they are high, or else they would go out of business. This may sound like an interesting point, but as

Charles Kindleberger (1984:272) has pointed out, the analysis does not hold water, neither theoretically nor when confronted with historical evidence. It simply disregards a large body of historical evidence on destabilising speculation and boom and bust cycles. Theoretically it overlooks the possibility that one can distinguish between a permanent group of insiders and a larger, changing group of outsiders. The outsiders, then, are typically drawn to the market too late, assuming unreasonable risk only to withdraw when they lose their money. This illustrates well the more general point that devaluing history in the pursuit of elegant deductive arguments can help sustain the bias against imagining that financial markets can go into dynamic disequilibria.

2.2.3 Imported dynamics

So far I might as well have discussed the forces that can pull functionally interdependent policies apart in the context of a closed system. That is, if we consider the mechanisms that produce asymmetrical degrees of stickiness and selective learning, we see that logically they do not depend on an environment external to the political economy to be operational. By introducing events and processes external to any given national political economy, we add another layer of complexity to the story. Imported dynamics can reduce the capacity to co-ordinate policies in at least three ways.

First of all, imported dynamics can be decisive for the timing of policy change. In international co-operation states often commit themselves to timetables and deadlines for implementation of policy measures. If such deadlines give rise to potential and understood co-ordination problems in a small and, in most respects, peripheral state like Norway, this will normally not be taken into consideration. Concerns for the “bigger picture” will not allow that. Furthermore, in exchange rate policy, market developments can “force” states to respond instantaneously. Secondly, external forces can have significant influence over the content of chosen policies. International agreements like the EEA treaty, for instance, produce a stream of fairly well specified measures that Norway is obliged to implement. Thirdly, external commitments can bring a quasi-constitutional quality to policy choices, introducing a source of stickiness or even downright rigidity to policies. The distinction between

these three ways that imported dynamics can affect co-ordination capacity is analytical. An important external influence like the Single European Market (SEM) impacted Norwegian economic policy along all three dimensions, timing, content and degree of stickiness.

The Norwegian economy is small and open and it is obvious that the external environment is a major and permanent concern in the formulation of “economic policy”, also the parts that are mainly debated in terms of domestic effects. These concerns date back to before concepts like Europeanisation and Globalisation became buzzwords, at least to the immediate post-war period. At that time a shortage of foreign exchange, capital goods and several other goods that could only be supplied in sufficient amounts from abroad had to be negotiated within a framework of national planning.⁵⁰ As regard the period in focus here, however, I will pick up the international part of the story from 1985 and onwards. Two changes in the external environment that occurred around 1985-86 motivate this choice. These were, firstly, the “reverse” oil price shock of 1986 that followed OPEC’s decision of December 1985 to defend market shares rather than prices (Claes 2000: chapter 5).

Secondly, the rejuvenation of efforts at achieving economic integration in Europe. The most spectacular aspect of this was the Single European Act (SEA), agreed upon in 1986.⁵¹ At the same time monetary co-operation through the European Monetary System (EMS) was improving in a more gradual way, noticeable through fewer and smaller realignments and convergent inflation rates (Gros and Thygesen 1992:85).

The oil price shock was a trigger - it helped sticky policies get unstuck. European integration had a similar impact in that it contributed to an understanding of the situation as new and demanding – a challenge to change. At the same time

⁵⁰ Einar Lie’s (1995) history of the Norwegian Ministry of Finance is an instructive read as regards this point. Time and again it demonstrates how those in charge of economic planning considered the effect of national policies on variables such as competitiveness and the current account.

⁵¹ Plans for the Single Market project were published in the form of a White Paper from the Commission in 1985. In 1986 the Single European Act was agreed upon and written into the Treaty. The Treaty revisions formally came into effect after ratification in 1987.

European integration influenced (and still influences) policy content as it provided a steady stream of “solutions” to more or less recognised problems. It also provided momentum to an ongoing process of change and it helped cement reforms already undertaken. The combined and immediate impact of the oil price shock and Europeanisation, however, was to contribute to a shift in policy stance from boom- to bust inducing.

2.2.3.1 Imported dynamics and policy timing

Institutionalist theory is useful for theorising why these external forces were crucial for the timing of the switch from over-expansion to super-contraction. I will start out from the general and abstract, but still widely held, notion that crisis is the most powerful agent of institutional change. I will then seek to develop more specific arguments on the impact of both the oil price fall and the SEM by drawing on Peter Katzenstein’s (1983, 1985) work on economic policy in small European states.⁵²

During the winter of 1985/86 the oil price plummeted from just below 30 US \$ to around 10 US \$. Figures outlining the gravity of this situation will be given in chapter five. Suffice it here to say that this had severe consequences for Norway’s current account position and the state’s finances. In both the introduction to this chapter, and in the section on learning, I have made references to the notion that performance crisis and institutional change are causally related. We need not give this insight a determinist formulation, that is, rule out that institutional change can sometimes be incremental and driven by small problems rather than swift and triggered by crises. We can, however, extract one expectation of relevance to this part of the study from these types of analyses. This would be that the time when routine-supporting frameworks (whether we want to call them institutions, paradigms or regimes) can be effectively challenged on a larger scale, is when their performances are particularly woeful. This means that while economic crises are damaging for many, they also herald new opportunities for economic policymaking.

⁵² Katzenstein’s cases are the Netherlands, Belgium, Austria, Switzerland, Norway, Sweden and Denmark.

In the section on selective learning the argument was developed that for technocrats to devote critical attention to policy routines a threshold measured in terms of negative performance has to be passed. But what represents a threshold-passing level of poor performance for technocrats might not be sufficient for democratically elected politicians to take action, at least not right away. Technocrats sit closer to day to day economic management than the average politician does. It takes time before problem awareness is diffused from the first group to the second. Although similar, politicians and technical specialists do not have identical concerns. Re-election is the most salient case in point here. This means that the typical politician has to pass a higher threshold (than the typical technocrat has to) before he is willing to support reforms that are unpopular with large or concentrated and well-organised groups.

At this point it is necessary to reconsider key arguments made in the section on asymmetrical degrees of stickiness above. In seeking to identify the kind of interest structures that hamper political change, that discussion inevitably painted a picture of democratic politics as prone to short-sightedness and easily hamstrung by particularistic interests and loss aversion. One problem with this kind of analysis is that in the absence of change in the underlying interest structure (or in the organisations based upon them) there is no reason to expect sticky policies to become unstuck. We also see that this perspective restricts the role of democratically elected politicians to being responsive and reactive to pre-existing interests. We can bring together theories that depart from interest structures and the institutional theory of change by relaxing this assumption. To do this we need to grant democratically elected politicians a more complex role. That is, to expect that sometimes they are reactive while at other times they can exercise leadership and define a common interest or at least adopt and communicate new ideas of common interest developed by the technocracy. It is more messy theoretically but also more truthful to describe the realm of democratic politics as housing a constant tension between ideals of governance for the long term and interest-captive short-termism.⁵³

⁵³ I am speaking here of motives informing policies. I wish to make no a priori judgements about the relationship between motives and results. Indeed in chapter 5 I will argue that the turn to

By drawing on Katzenstein (1983, 1985), this argument can be developed further in the direction of specifying when to expect stasis and when to expect that the Norwegian political system should display a capacity to go through with troublesome reforms. In order to do so it is necessary to give a rough outline of Katzenstein's key points. His analysis proceeds in the following steps. Firstly, "smallness" creates a functional need for an open foreign economic policy, both on the import and export side of the equation. Small economies can neither be self-sufficient across the broad spectrum of material wants that a modern society has, nor can they provide domestic producers (exporters) with a big enough market to sustain economies of scale. In order to compete in this liberal environment competitiveness is sought developed through incomes policies. But even if these efforts are successful some firms and even sectors lose out, and the costs of this adjustment is therefore to some degree sought socialised by policies (welfare and industrial) that he calls "domestic compensation". The combination of liberal foreign economic policy and domestic compensation Katzenstein describes as a policy of "flexible adjustment". We see that so far the argument is primarily functional. "Smallness" creates functional imperatives, and the processes that secure the transformation of these imperatives into actual policy are consensus oriented elite co-ordination which takes place within corporatist institutions originally developed during the inter-war crisis. Katzenstein (1985:80) defines corporatism broadly, including both the institutional set-up and the spirit that animates these institutions.

An ideology of social partnership, a centralized and concentrated system of economic interest groups, and an uninterrupted process of bargaining among all the major political actors across different sectors of policy.

By and large Katzenstein's normative conclusions were positive. Based on an interpretation of his case countries' experience with flexible adjustment in the 1960s and 1970s, he concluded that their strategies had proved successful judged by criteria such as unemployment and inflation performance and (absence of) social dislocation. By the late 1980s, however, doubts as to the continued efficacy of the models he

tighter macro-policy was unfortunately timed and overdone, hence the chapter title "too much too late".

admired were being raised. Articles with titles such as “flexible adjustment or paralysing rigidities” (Mjøset 1989) were typical.⁵⁴ There is in other words an inherent ambiguity in Katzenstein’s argument. It can be helpful to spell this ambiguity out.

One the one hand the Katzenstein story can be told as one of rigidities. In this version corporatist demand for consensus becomes a weakness. Vested interests hamper the transfer of resources from declining sectors to sectors on the rise. Domestic compensation and co-ordinated wage setting across sectors make people stay where they are. And in Norway’s case it is not just the corporatist institutions that underscore the consensus-orientation. The parliamentary arena reinforces this. With minority or coalition governments (or both) – the need to strike compromises becomes not only a functional imperative, but also a parliamentary necessity. In terms of the discussion of parochial short-termism versus leadership in governance, the expectation to be extracted is that a culture that values and a polity that all but enforces consensus-orientation, hampers large scale change in the absence of crisis. This culture and institutional set up can be seen as imposing something akin to a Pareto criterion to broad scale reforms, and thus make them very hard to push through. By slightly twisting Katzenstein’s point of departure, one can thus develop a macro perspective on the more finely grained stickiness discussion conducted in section 2.2.1.

The second version of the story focuses the solidarity and enlightened self-interest that animates the corporatist and parliamentary institutions of a state like Norway. This translates into an ability to achieve gains from collective action. The standard example of this logic is incomes-policies that keep wage-inflation in check so that broad gains in terms of employment performance and real income are realised. It is in times of crisis, however, that the real strength of this culture and institutional set up as a system for producing tough decisions can be expected to come through. It follows from the spirit of Katzenstein’s analysis that in such circumstances elites can be expected to cut through what in good times appeared to be irreconcilable differences, redefine interests through learning and find new common ground.

⁵⁴ The full title of the article was “Norway’s Full-Employment Oil Economy – Flexible Adjustment or Paralysing Rigidities”.

A “Katzensteinian” perspective can be used for more than formulating propositions about the timing of the turn to austerity. It can also help us understand the Norwegian response to the SEM process. The key here lies in his argument that small economies produce a functional imperative towards liberal foreign economic policies. Policies facilitating openness were taken for granted by the Norwegian elites. They were used to joining up with international liberalisation initiatives be it within the framework of the OEEC, the EFTA-EEC nexus or GATT. Conventional wisdom was and still is that Norway cannot afford to be by-passed when such initiatives are made. At the same time the question of membership in the EC/EU were, and still is, highly controversial. Painful memories of the disruptive fight over membership in 1972 informed elite perceptions of how the issue should be handled. When the SEM appeared as an imminent and credible fact, this in effect pitted two deeply embedded values against each other. The challenge that faced Norwegian political elites at this juncture was to maintain the tradition of defending market access for Norwegian producers and products, without undermining the tradition for consensual (foreign) policy making. In this light the EEA (European Economic Area) process can be viewed as a search for a national compromise. The EEA treaty (which essentially gives access to the SEM without membership – or influence on the policy of the EU) did not formally come into effect before in 1994. As we shall see in chapter five, the SEM established timetables for Norwegian policy making in several issue areas long before that.

2.2.3.2 Imported dynamics and policy content

The second way in which imported dynamics influence national co-ordination capacity is through influencing the content of chosen policies. The content of economic policy can be influenced through different channels. We can distinguish between a legal channel, a market channel and an ideas channel. I suggest the concept of channels as a heuristic device.⁵⁵ The distinction drawn here does not imply that they

⁵⁵ These terms and their definitions are not identical with, but it still rely heavily on work I have done together with my colleague and friend Dag Harald Claes in an edited volume on the

are mutually exclusive. To the contrary, one can expect to find that processes in one channel are being reinforced by processes in another. Or that a process that begins in the ideas channel (as learning) gradually gets formalised and is thus concluded in the legal channel.

In general the introduction of a concept like the *legal channel* is useful for capturing the growth of legally binding international commitments that governments are taking on through global institutions such as the World Trade Organisation or regional organisations such as the EU or NAFTA. In this specific analysis, however, I will refer purely to the EC/ EU. Focusing on the legal channel entails seeing the EU as a lawmaking entity producing numerous regulations, directives and decisions. These take precedence over national law also in an EEA-state like Norway. In Norway it is taken for granted that the government will implement and respect the legislation that comes out of the EU. At the time of writing (March 2000) Norway had not yet once exercised its right to refuse European legislation.⁵⁶ The concept of a legal channel must also take into consideration the power of the European Court of Justice. Relevant rulings are also binding for the EEA.⁵⁷

In general, Europeanisation can be said to contribute to a redefinition of the legal and the political sphere (Sejersted 1995). This means that arguments, institutions and actors we are used to viewing as part of the legal sphere, come to play a more prominent role in policy making. The introduction of European legislation on the national level can also supply “old actors” engaged in “old conflicts” with new weapons. But this redefinition also provides an incentive for policy makers to try and influence lawmaking or to challenge the authority of legal bodies – often tacitly – by

impacts of European integration on Norwegian policy, (Claes and Tranøy 1999:24-27). The two main differences is that in that volume the focus is not restricted to economic policy, and that we employ a concept of “modes of adaptation – *tilpasningsmåter*” rather than the concept of “channel” which I prefer here.

⁵⁶ Although it was widely anticipated that Norway would oppose the EU directive on genetically modified food.

⁵⁷ Formally this only extends to rulings made earlier than May 1992, something which gives the EFTA countries “a slightly larger margin of national discretion” .So far however, the EFTA court has not emphasised this distinction (Sejersted 1997:53).

purposefully not implementing directives in the spirit of the lawmakers. The legal channel can also provoke anticipatory policymaking. This will be the case if national policy making processes are influenced by adaptive requirements policy makers expect will be produced at the European level in the near future. In this case study, the focus is on the period up until the EEA-treaty came into operation in 1993. This means that different aspects of such anticipatory processes are of particular importance here.

The *market channel* mediates between the international and the domestic level in a more indirect manner than the legal channel does. The concept refers to how change in the territorial scope of markets can produce changes in the constraints and incentives faced by governments through bringing previously insulated markets into competition with each other. The most important mechanism is that more mobile capital induces governments to change their policies in order to influence capital's decisions on where to locate. The one area where increased capital mobility probably has had the clearest and most direct effect is monetary policy. The increasingly mobile status that portfolio investments in currencies have achieved over the last 30 years or so, means that executioners of monetary policy live with a serious constraint on a daily basis. Although the size - and sometimes even the direction - of the impact is difficult to predict, interest rate changes will normally influence the exchange rate, and the medium of influence is mobile capital. The relationship between interest rates and exchange rates that is most commonly assumed (and observed) is that relative interest rate increases attract capital, and so serve to strengthen the exchange rate. Financial markets are, however, largely driven by expectations and on occasions interest rate hikes seem to have been interpreted as signs of weakness. In such cases interest rate hikes have been followed by a weakened currency.⁵⁸

The worst case scenario for any given state is when negative expectations turn into self-fulfilling prophecies with capital leaving in droves setting off a downward

⁵⁸ Conversely there have been cases where interest rate reductions have been followed by appreciation of the exchange rate. A recent example of this occurred 23/4 1999 when NOK was strengthened versus the Euro and the Dollar in the aftermath of 0.5 percentage points cut in interest rates by *Norges Bank*.

spiral of a falling exchange rate, increased interest rates and general economic downturn. This is particularly damaging if the country in question has a large debt denominated in foreign currencies. Such debts become increasingly hard to service as the exchange rate falls. But capital inflow can also cause governance complications if the amounts are large enough. Aiming for a fixed exchange rate can make it extremely hard to co-ordinate interest rate policy with other macro-economic policies. Such problems will be particularly acute if a country seeks to maintain a fixed exchange rate against the currency of an economy with which it is out of step in terms of the business cycle. In such a situation interest rates “imported” from the economy one is stabilising against can lead to monetary policy having a pro-cyclical effect. That is, upward pressure on interest rates in a downturn and downward pressure on interest rates during an upswing.⁵⁹

Most currency speculators live off short-term trades. In this sense the capital owners who influence monetary policy most are almost continuously exercising their newly won right to move. But the key here is to possess the right to move, not actually exercising it. If Governments are constrained in their policy choices by their desire to influence decisions on location, it follows that it is not necessary to actually move to achieve leverage over policy. Interest rate levels are often set with the aim of minimising capital movements. Threats of relocation can thus be general and implicit or they can be explicit and linked to a specific actor. Sometimes threats don't even have to be formulated. This would be the case if a Government lowered its labour standards and/or its level of taxation – pre-emptively in order to avoid what is commonly referred to as social and fiscal dumping. The aggregate results that the fear of social and fiscal dumping can lead to can be described as a “race to the bottom”. Regulatory levels of ambition are falling because states compete over investments. One can, however, also imagine “races to the top”. In banking regulation this is a relevant scenario. Governments may fear that their banks will lose out when competing for

⁵⁹ The difficulties inherent in simultaneously managing the exchange rate, interest rates and mobile capital were first theorised by John Fleming (1962) and the Nobel laureate of 1999, Robert Mundell (1963) in the 1960's when capital was highly regulated. More recently Benjamin Cohen (1993) has introduced the evocative term “Unholy trinity” to capture the same dilemma.

funds and customers if, for example, their capital requirements are not seen as adequate compared to those their competitors are subjected to.

The concept of an *ideas channel* refers to situations where national policy makers learn from or imitate European solutions to problems (or imagined problems) From the (new) institutionalism literature we can draw a crude distinction between two types of processes here. One kind of expectation is that institutions will not lose sight of their own traditions and experiences and thus display significant autonomy when learning from the environment (March and Olsen 1989). On the other hand we have an expectation of a less autonomous and more uncritical type of learning. The generation of this expectation follows from reading the “sociological” variant of neo-institutional organisation theory for our purposes. The most important environment for any given organisation is not its local community. Isomorphic processes occur across organisational fields roughly following the borders of professions, industries or nations. Fields contain all of the relevant organisations from the point of view of actors in any given organisation (Fligstein 1991:313). Increasing similarity occurs because organisations are penetrated by the cognitive lenses (referred to as classifications, schemas, scripts and routines) that dominate a given field, and come to view them as their own.

On a more general level we can note that the two varieties of new institutionalism focus on what we might term the demand and supply side of a learning process, respectively. This split should not be overemphasised. In empirical research it is important to study both these sides. That is, study both how demand for learning originates within a given problem’s specific institutional context, and the supply of potential solutions defined by the broader institutional field.

2.2.3.3 Imported dynamics and policy rigidity

The third way in which imported dynamics influences national co-ordination capacity is through bringing a quasi-constitutional quality to policy choices, introducing an external source of rigidity to policies. In general, international commitments reflect a trade-off between what is perceived to be the common good and

the more myopic preferences of individual states. Collective action therefore requires individual restraint. There are several possible mechanisms that can help bring about such restraint. Firstly, and as already brought up in the discussion on the legal channel, there is a fairly strong norm of compliance in Norway's relationship with the EU. This reflects a broadly shared understanding among Norwegian policy makers that the EEA treaty is better than no treaty. To secure access to the European market for Norwegian goods, services, capital and people, some costs have to be borne. This holds even if these costs are not as a rule borne by the same actors that stand to gain. To some degree the benefits and costs are not even measurable in the same "currency" (wealth versus democracy and sovereignty). For society as a whole, however, the costs accrued are perceived as acceptable by a large majority of decision-makers. In a "Katzensteinian" perspective, some sort of attachment to the Single Market was probably seen as a necessity by this majority which, if true, means that Norway entered into the negotiations very keen on emerging with an agreement.

Secondly other participants can retaliate against parties that do not respect their commitments. In an asymmetrical relationship like the one the remaining EFTA-countries have to the EU, the possibility of this happening is more than remote. Norway needs the EU more than vice versa, in effect the relationship is characterised by what Keohane and Nye (1977) called asymmetrical interdependence. Interaction between the two is continuous and it takes place across a multitude of issue areas simultaneously. This state of affairs gives the EU broad scope for punishing Norway.

A third motive for showing restraint can be the desire to build one's credibility. International co-operation does not take place in a time warp and since there are likely to be a demand for negotiated solutions in the future, credibility is an asset. State-state relationships are, however, not the only type of relationships where credibility can be seen as a resource. States also seek to build up credibility in their relationship with wage earners. If a government lacks credibility on inflation, this can lead to inflationary expectations being built into wage demands thus producing an inflationary spiral. Credibility on inflation is also important vis-à-vis holders of capital, particularly mobile capital. In general, the proposition that the economy functions best if

government can produce a stable and predictable business environment is often voiced as an argument against discretionary policymaking.

Ideas of this kind emerged early on in the literature on political business cycles.⁶⁰ In turn this led to an interest in rule-based fiscal policy.⁶¹ Lately emphasis has been on monetary policy. The single most important argument for the close to world-wide move towards granting central banks more independence that has occurred in the 1990s, is the belief that technocratically run institutions are likely to be more single-minded and thus more credible in their stance against inflation. This in contrast to institutions dominated by democratically elected politicians, who by those who are inclined towards that kind of thinking, are assumed to take a broader, more short-term, and according to some, “time inconsistent” view.⁶²

The policy advice that comes out of this pessimistic view of democratic governance of the economy emphasises the importance for governments of upholding strong, transparent and credible commitments. Rules, rule over discretion. The ideal of autonomous central banks with inflation targets made public is the most obvious example. But the logic whereby credible and transparent commitments are recommended has also been operationalised with the exchange rate in the crucial role.

⁶⁰ The idea of political business cycles is essentially that incumbent administrations “pump up” the economy via fiscal and/or monetary policy before elections in order to reap electoral benefits. The classic formulation is that of Nordhaus (1975).

⁶¹ See Keech (1995 chapter 7) for discussion of this topic. The rest of his book examines other aspects of what I below call the pessimistic view of democratic governance of the economy. The first chapter for instance, is titled, *Macro economic policy and the costs of democracy*.

⁶² Kydland and Prescott (1977) developed the theory of time inconsistent inflation preferences. It can serve to illustrate the negative view of democratic policy making that were endemic to theories that lend themselves to the conclusion that policy should be based on rules rather than discretion. In Sweden this view was very popular in the 1980s and the term “Norm politik” was coined (Söderström 1996). Kydland and Prescott’s theory posit that in reality Governments are bluffing when claiming that they want low inflation. Thus they entice economic actors to enter into contracts that presuppose low inflation, only to withdraw their promise and seek the benefits of monetary expansion instead (that is, increased employment and growth, and this without the inflation one would normally expect, since contracts have already been entered into). In the next “time period”, however, economic agents are wiser, and adjust their expectations accordingly. This is inflationary in it self. The long-term consequence is an equilibrium with higher inflation than necessary and no real growth in employment. Berre 1996 gives an excellent review and analysis of different strands of neo-liberal thought on these issues.

A belief underpinning this strategy is that such states – and particularly if they have used devaluation as an instrument in the past – need to prove to financial markets that they are willing to accept short-term pain in order to maintain their long term commitment. In the 1980's it became common to interpret (part of) the differential one could often find between interest rates in West Germany and the countries that fixed their currencies to the DM as a “risk premium” that investors demanded to keep their funds in the less credible currency.⁶³ It followed from this that countries that were able to increase their credibility would be rewarded with lower interest rates – other things being equal. Generally speaking changes in credibility seems to be self-reinforcing processes. But if patience is the name of the game for countries engaged in “credibility building”, the mechanism of self-reinforcement can – as was hinted at when discussing free falling exchange rates above - be brutally efficient when credibility is on the way down.

2.2.4 Summary

After trying to clarify a set of more general and meta-theoretical issues in section 2.1, the main part of this chapter has concerned itself with developing the notion of disparate policy paths. My presentation of these three different sources of co-ordination failure should be viewed as a rough typology. The theoretical ideas gathered under the headings of asymmetrical degrees of stickiness, selective learning and imported dynamics respectively structures each of the historical narratives of chapters three, four and five. But it should be added this structuring is mainly implicit. It has governed which policies are described where. Also, this analytical concern has been weighted against other, such as chronology and what we might call the narrative flow.

As discussed in the introduction, this study is not set up in a manner that allows for the testing of hypotheses in a conventional, control-oriented manner. Presenting the theoretical arguments in a relatively concentrated form in one chapter, should, however, serve to make them clearer and to facilitate a structured analysis of my

⁶³ On the notion of risk premiums, see also chapter five, subsections 5.1.2 and 5.3.1.

findings. Because, not undertaking hypothesis testing does not imply that the theoretical ideas developed in this chapter are not confronted with empirical findings. It is my aim to give a theoretical interpretation of the case materials. This is done in chapter six. There, under the heading “local conclusions” the findings from chapters three, four and five - and the theory just presented - are brought together. In chapter seven I seek to move towards a higher level of abstraction. In that chapter more general questions, pertaining to the overarching issues of institutional order and disorder and more established theory are addressed.

Chapter 3: The boom years – unfortunate sequencing as a function of asymmetrical degrees of stickiness

As noted in the introduction, the Norwegian credit market hyper expanded in the years from 1984 to 1987.⁶⁴ This period I define as the boom years. The policies and politics that impacted the boom are discussed in two separate chapters, chapters three and four respectively. The distinction between these chapters is analytically motivated. In chapter three I investigate how the relationship between credit controls and other policies - that affected either the price of credit or the price of collateral - were separated by a logic of asymmetrical degrees of stickiness. That is, I am interested in how a profoundly sub-optimal sequencing of events resulted from the fact that the market for housing and shares were easy to liberalise while interest rate and tax policy proved to be sticky. Further it is argued that this sequence was determined by variation in how interests in different issue areas were structured, mediated and perceived. In chapter four the theme of how functionally interdependent policies were separated from each other is expanded upon, empirically and theoretically. Through the notion of selective learning aspects of ignorance and insufficiencies in the flow of information that reached decision-makers is highlighted. The main theme is how all actors involved systematically underrated the risks that flowed from liberalising the credit market. This phenomenon is particularly visible in precautionary policy.

Turning to the internal organisation of the present chapter this reflects that credit control policies are given what we might call analytical and narrative primacy. Credit control policy provides a baseline against which the appropriateness of other policies are measured. This is so because co-ordination is defined in terms of how well other policies were adjusted to the changes in market conditions brought on (and seen over time also reflected by) the repeal of credit controls. Subsequently this makes it

⁶⁴ For figures on this expansion see subsection 3.3 below.

important to give a precise account of when and how credit controls were scrapped. As we shall see, at least one well respected historian of the period disagrees with the notion that there was ever a formal decision to liberalise the credit market. My view is that there was such decision – in 1980 - and that this reflected a first triumph for a group of neo-liberal policy intellectuals dominated by technocrats from *Norges Bank*. Gradually this triumph was converted into actual policy, although this was a time-consuming process.

In section 3.1 the background for the liberalisation process of the 1980's is presented. In the following section (3.2) the repeal of credit controls and the resultant credit boom is described. In section 3.3 policies towards the markets for housing and shares are outlined. Because these reforms ran relatively smoothly through the political process these markets were, so to speak, ready to interact with the credit market when credit controls were lifted. In section 3.4 the stickiness of interest rate controls and tax breaks even in the face of hyper-expansion is accounted for. Section 3.5 expands the economic policy context further by looking at fiscal and incomes-policy in the growth years. At that point the narrative on asymmetrical degrees of stickiness ends.

3.1 Credit liberalisation: the background

This section contains two subsections. In the first of these the historical background for the formal decision to liberalise is outlined. I describe how the technocrats in the central bank interpreted their problems in governing the market, and how this led them to press for liberalisation. The pressure yielded results in the form of decisions, but as we shall see, implementation did not follow automatically. This has given rise to a debate over what was decided when. Since I take the position that there was a formal decision to liberalise, I also need to engage the debate over whether such a decision was actually made. This is done in subsection 3.2.

3.1.1 Historical preamble

The history of what I call the Social Democratic Credit Regime (SDCR) can be seen as consisting of two distinct phases, according to the legal status of the tools employed. Between 1951 and 1965 negotiations between the authorities and

representatives of the financial institutions were institutionalised in *Samarbeidsnemnda*. This bi-partite arrangement resulted in agreements restricting the supply and price of credit from the private sector. The state issued and guaranteed bonds, the purchase of which was negotiated in *Samarbeidsnemnda*. Since bond-issuing institutions were thereby secured a market for their papers the authorities had to control issuance through legislation. The basic elements of this model were sustained until the early eighties, but the regime regulating the relationship between the state and the private financial institutions went through a major revision in 1965. At this junction negotiation in *Samarbeidsnemnda*'s was largely replaced by more direct government control based on new and highly elaborate monetary and credit legislation drawing on the work of the British Radcliffe committee. The private financial institutions protested by withdrawing from *Samarbeidsnemnda*. Corporatist style contact between the parties was not given up however. New fora were set up soon after the 1965 regime change.⁶⁵

The key instruments of the new legislation were adjustable primary and secondary reserve requirements that were meant to regulate the liquidity of the banks thus, in theory, enabling the authorities to release the optimum volume of credit at any given time. For periods of very strong credit demand there were supplementary reserve requirements that were meant to function more or less as direct controls. Unlike the primary and secondary requirements that were calculated from the banks total capital, the supplementary reserves were measured in relation to increases in lending compared to discretionary given upper limits. The new legislation also contained paragraphs enabling the authorities to regulate the lending of non-bank institutions operating in the Norwegian credit market. Managing institutional liquidity directly like this, while at the same time straight-jacketing the bond market, had the additional effect of obstructing the development of significant money and bond markets in Norway. In turn this precluded the use of direct market operations in monetary policy.

⁶⁵ In 1966 *Det kredittpolitiske utvalg* consisting of the same parties as *Samarbeidsnemnda* (with the addition of representatives from the state banks) was established. In 1970 this was in turn replaced by two new organs, of which one, *Det kredittpolitiske samarbeidsutvalg*, had a secretarial function for the other, *Det kredittpolitiske råd*. While regulation of the credit volume was now subjected to a more clear cut case of command and control, interest rate levels continued to be negotiated (at least formally) within this corporatist framework.

When Samarbeidsnemnda was replaced by direct legislation in 1965, this signified a high point in the optimism of the technocracy of economic policy making. Bi-partite negotiations were considered too slow and imprecise, for the rising ambitions of macro-economic management nurtured by the economists of the Oslo School". The expert report that prepared the new legislation is a clear manifestation of the prevalent mood among the majority of the economists.⁶⁶ Three main premises, all central to Oslo School-economics, can be identified. First macro-economic "fine-tuning", wherein credit-supply had a major role to play, was both possible and desirable.⁶⁷ The commission even went as far as suggesting a regionally differentiated fine-tuning through regionally differentiated credit rationing. Second, the development of the real economy had a fundamental priority over the monetary sphere. The monetary economy was seen as easily manipulated for "real" ends. Not through flexible interest rates though, which was seen as an undesirable, blunt and unreliable tool. Instead the majority of the commission behind the paper recommended a more direct management through influencing the liquidity of the individual institutions (see section 2 above). A liberal conception of the credit-market as any other market, where interest rates functions as the price of a homogenous good, was absent from the majority position. There wasn't even a concept for money supply in the theoretical framework employed by the commission. The third premise was a strong belief in the efficiency of political/bureaucratic allocation of credit.

The phasing in of the new legislation coincided with the first non-socialist parliamentary majority in Norway since the war. In a societal interest perspective it is surprising that the broad coalition of non-socialist parties that formed Government in 1965, immediately utilised the regulatory tools handed over to them by the out-going Labour-administration. Government partisanship had no impact on monetary policy what so ever. As regards the relationship between the banking industry and the

⁶⁶ Innstilling fra den penge- og kredittpolitiske komité, Finans og tolldepartementet 1964.

⁶⁷ Good discussions of the "Oslo School" by economic historians are to be found in Bergh and Hanisch (1984), Lie (1995) and Søylen (1998)

authorities it can be noted that overshooting most certainly rose from the first year the new instruments were in use. In 1966 credit supply to the economy exceeded the credit budget target by more than 20 percent.⁶⁸ It also says something about state-bank relations that in 1966 the authorities actually informed the banks in advance that they were preparing a round of supplementary reserve requirements. Several banks reacted by immediate accounting measures designed to inflate their balances, the purpose being to elevate their datum points. The Ministry of finance never showed their hand this way again, but a new game had been introduced. A game of evasion and ever more detailed regulation which as it developed took an increasing amount of the energy of both regulators and those regulated. In pure overshooting terms some years were better than others, but in the 20 years the regulatory apparatus of the 1965 law was in use, overshooting was a recurring and increasing problem in terms of both scale and frequency.

This stimulated the research department of the Central Bank to try and develop better tools for understanding the process shaping the demand for credit in the economy. In accordance with the "Oslo-schools" relative negligence of the monetary economy, initial estimates of credit demand, the main input variable in the credit budget, were calculated in a primitive manner. In fact, the estimate was based on a model projection of demand for real investment in all sectors. This was a crude measure because it ignored such factors as the use of retained profits for investment, the use of credit for building up cash reserves and the use of credit for consumption. While the first factor, other things being equal, contributed to underestimating demand for credit, the other two had the opposite effect. On top of this the Central Bank had no

⁶⁸ NOU 1989:1: table 4.1. Comparable numbers for the years before 1966 have not been calculated. And since Samarbeidsnemnda did not produce legally binding agreements but something more akin to "gentlemen's agreements (with the threat of legislation if it did not work) there was room for contesting how these agreements should be interpreted. Still, available information indicates that in the most expansive years of Samarbeidsnemnda, and in the least liberal interpretation, overshooting was seldom higher than 10 percent (Graff-Hagen 1977:119-124).

real tool for breaking down and distributing credit on the different institutions engaged in lending activity.⁶⁹

The fact that these tools were so primitive seemed at the time to bode well for chances of improving the management technology without moving beyond the prevailing cognitive framework, that of the "Oslo-school". In the language of a Kuhnian metaphor: At this stage credit overshooting remained a "puzzle", it was the deftness of the regulators that was being tested, not the cognitive framework informing their efforts. Efforts to remedy the weaknesses highlighted above were undertaken with a large project to model the credit-economy: "Krøsus". But the results were less than inspiring. Overshooting persisted and increased in the mid-seventies, as the counter cyclical policies of the 1974 to -76 period made their impact felt. With the benefit of hindsight it easy to see that the social democratic credit model was overextended in these years. Nominal interest rates were rigidly low, as deficit spending and subsequent inflation directly, and through bracket creep, brought real after-tax interest rates into the negative. The unsuccessful search for intra-paradigmatic improvement of management tools within the framework of the "Krøsus"-project stimulated a process of theoretical reorientation within the central bank. In Kuhnian terms the "puzzle" became a "problem" for the Oslo-school framework. Inflation rose to the top of the professional agenda. In its internal research the bank went further and further along a quasi-monetarist path, placing monetary aggregates at the centre of its analytical attention. It was argued that without utilising the price mechanism the volume of the (now conceptualised as homogenous) "good" credit, could never be managed. Credit controls would just serve to stimulate grey markets if the price of credit (the interest rate) was kept below a market clearing level.⁷⁰

⁶⁹ Author's interviews with Jarle Bergo 10. & 15.06.1992. Bergo was directly involved in the "Krøsus" project in *Norges Bank*.

⁷⁰ In "grey" markets, transactions are - in order to circumvent regulations - conducted directly between non-institutional lenders and borrowers, but where the finance-institutions normally continue to play a de facto role as an intermediate, for instance by underwriting the transaction.

The first sign of a breakthrough for this advice vis a vis democratically elected politicians came in 1977. At that time the counter cyclical policies of the mid-seventies were being called off in the face of large fiscal deficits (a novelty in post-war Norway), close to two-digit inflation and record-breaking current account deficits (almost 14 percent of GNP in 1977). Interest rate control was temporarily abolished and rates were allowed to climb by two percentage points before a wage and price freeze was implemented in 1978. Even though the suspension of interest rate control only resulted in after-tax interest rates just creeping back above zero for average incomes, the symbolic value of the move was important and political reactions inside and outside the governing Labour party were strong. A parliamentary commission was duly established and the "pedagogic" purpose it was meant to serve is clear from the way it was composed. Its leader was a newly converted old-guard economist and former Labour Minister of Finance,⁷¹ while among the members vociferous supporters of the old system, primarily from the (agrarian) Centre Party and Labour's youth movement, was only outnumbered by economists of the new persuasion.

The resulting report delivered in 1980 presented a text-book neo-liberal analysis.⁷² A liberalised market for credit was recommended for reasons of macro economic management, allocative efficiency and (re)distribution (it was documented that high income groups were better at utilising the system of cheap credit and tax breaks than lower income groups). But even though the analysis pointed unambiguously towards a free market, a small reservation was hooked on at the end. Only the bond market should be free to find an equilibrium price, while the price in the market for bank credits of a duration of more than one year should be standardised at an *estimated equilibrium* rate based on bond market movements (NOU 1980:4:15).

In other words: The conclusion was that one should continue with administered prices in the credit market, but that one should seek to simulate the equilibrium price. The administration of interest rates had to be highly flexible, not inflexible and

⁷¹ Peter Jacob Bjerve who led the committee was among professor Frisch' first students in the new discipline of "social economics" in the late pre-war years at the university of Oslo.

⁷² NOU 1980:4. Rentepolitikk

oriented towards the goal of keeping it as low as possible as had been the rule until then. Hence in the circumstances flexible administration was really a polite way of saying that interest rates should rise. From the point of view of the politicians receiving the report the wording was nevertheless important. It was important because it created an opening for continued political management *of* more than *through* interest rates. Interviews with the central actors of the day clearly indicate that facilitating continued political discretion was necessary to get the report through parliament.⁷³

3.1.2 Liberalisation – by decision or did it just happen?

In one sense the word game worked since the report of *Renteutvalget* achieved a general if vague acceptance in Parliament. At the same time one could say that the ploy backfired since it laid the foundations for a revision of interest rate policy routines which nevertheless implied five more years of political management of interest rate levels with a downward bias. The ambiguous language of the report has also led to scholarly disagreement over the significance of the report and its reception. The economist Erling Steigum (1992a:24) has claimed that the subsequent political discussion in parliament revealed an all-party acceptance of the “intentions” behind the analysis of *Renteutvalget*. From this basis he goes on to read the monetary policy history of the later years as a gradual implementation of the report’s recommendations. The historian Einar Lie (1998:74) refutes this and marshals both contemporary statements and subsequent political (in)action as his evidence. Lie’s position is firstly that there was no consensus. Secondly that one should not read the history of monetary regulation in the eighties into the schema that emerges if one reads the planning documents where the reforms were suggested. Exactly what Lie wishes to substitute for what he evidently sees as a quasi-teleological perspective on liberalisation is less clear. His emphasis is on arguing that neither the reception of the 1980 report nor the 1984 decision to lift the most important credit controls (see below) reflected more than

⁷³ Author’s interview with Ulf Sand (04.06. 1992) and Hermod Skånland (18.06 1992). Sand knew this story from both sides. He had to withdraw from *Renteutvalget* because he became Minister of Finance while the committee was still at work. In his new capacity he received the report on behalf of the Government.

a gradual and reversible adjustment of policies. In his eagerness to highlight the short-sighted decision making horizon of politicians (and bankers) of the period, he offers no overarching view nor an explanation of the fundamental changes Norwegian credit market regulation and monetary policy went through in the years from 1980 to 87. In a way the phenomenon I want to understand - liberalisation – is fragmented to the point of vanishing in an argument such as Lie's.

Thus neither Steigum's exaggeration of the degree of consensus following "Renteutvalget's" report, nor Lie's singular emphasis on proving that there never was a master plan, nor a clear water-shed is satisfactory as a starting point for an analysis such as this. What we need instead is a picture of an evolving conflict between reformers and recalcitrant sceptics of various shadings where the reformers gradually gained the upper hand. The reformers wanted dramatic change, fast while the sceptics tried to water down the expert advice when translating it into policy. In this perspective it takes on significance that when "Renteutvalget's" report was dealt with by the political system, the *arguments* presented in the report were (as I will show below) never taken issue with. The sceptics had no alternative analysis to offer, just a practical opposition to its conclusions. In one interview a representative of maybe the staunchest low interest party - the Centre Party - has admitted that members of Parliament felt highly disadvantaged if they tried to argue openly against the expert consensus established in *Renteutvalget*.⁷⁴ Thus an expectation of which way credit market regulation and monetary policy was going was gradually established. This shaped the intellectual climate in which policy ideas were conceived and interpreted. It also fuelled a desire for a more liberal market order among the banks and other financial institutions.

The specifics of this story that need concern this analysis are these: The revised national budget for 1980 built on the potential for compromise inherent in the ambiguous conclusion of the report. In the budget document the government accepted the main thrust of the analysis of *Renteutvalget*. It also recommended a liberalisation of

⁷⁴ Authors interview with Ole Gabriel Ueland, 15.06.1992

the bond market and increased of open market operations on the part of the central bank. It further endorsed the view that interest rate policy needed be administered in a more flexible manner. On the other hand, the Government was more direct than *Renteutvalget* ever was on the need for political discretion. While *Renteutvalget* had talked about insufficient competition in the credit market, the budget document spoke of “avoiding a transfer of power from the authorities to the institutions of the credit market”.⁷⁵ The need to find a compromise resulted in an even more unclear language when the Finance committee of the Storting wrote their recommendations on the revised national budget. While the committee’s majority (Labour, Conservatives, Centre Party and Christian Democrats):

...acknowledged the importance of interest rates levels for how the credit market works and therefore for controlling credit supply....,

The majority also stressed that managing the supply of credit (i.e. credit controls) was of even greater importance.⁷⁶ This was followed up by a short-lived attempt to liberalise the bond market, an attempt that was aborted a year later because the market grew too fast. Apart from this, business was as we shall see below, continued more or less as usual.

3.2 Cascades of credit – repeal of volume controls

A change in government as Kåre Willoch replaced Gro Harlem Brundtland after the 1981 electoral triumph of the Conservatives, did not bring matters further along.⁷⁷ In contrast with their market friendly rhetoric (and actual reforms in other sectors), the Conservatives were in no hurry to dismantle the market-thwarting model of credit regulation. Judging from the political history of credit market regulation this is perhaps not so surprising. All of the parties represented in parliament in the period from 1965 to 1980 virtually ignored credit policy in their programmes for this period (Tranøy

⁷⁵ St. meld. nr.80: 86-87

⁷⁶ Budsjettinst. S.IV – (1979-80):9-10. See also pages 17-18 for a detailed comment from a minority composed of two of the parties behind the majority recommendation, the Centre Party and the Christian Democrats.

⁷⁷ The Conservatives held office on their own, but with the acknowledged support of a non-socialist majority in parliament.

1993a:205-206). It is more noteworthy that this trend persisted also after 1980. A review of party programmes for the 1981-85 reveal not attempts at including credit policy in the discourse of neo-liberal reforms.⁷⁸ As will be discussed in some detail in subsection 3.4.2 below, the Willoch administration, in stead of initiating change, preferred to hide behind the notion of “estimated equilibrium rate” as a cover to continue a policy of rigid interest rate regulation. To support this policy, however, they for a while continued utilising the full arsenal of credit controls that legislation opened up for. The gradual repeal of these controls is the subject matter of this section.

The reformers in the bureaucracy were not happy with this standstill, and neither were the banks who had built up expectations in the wake of *Renteutvalget*'s report. Particularly Norway's second biggest bank, *Kredittkassen*, held great expectations, and its leadership also strove to make the Norwegian Bankers Association more active in promoting implementation of the recommendations in the report (Knutsen 1998:248). Through an initiative taken in the main corporatist institution of the credit market (*Det kredittpolitiske samarbeidsutvalg*) these forces were handed another chance to express their views. A committee consisting only of economists of the new persuasion was asked to review goals and instruments in credit policy.⁷⁹ Their conclusions were fully consistent with those of their predecessors of three years earlier. They suggested that less focus should be put on sectoral allocation of credit and more on monetary aggregates in order to control inflation. They criticised

⁷⁸ There are at least two reasons to have expected more of a democratic discourse on credit policy after 1980, one general reason and one reason more specific to the Conservatives. The general reason is that the report of *Renteutvalget* was published in 1980 and treated in Parliament the year after. This could ostensibly have put the issue of credit reform firmly on the agenda. The motive specific to the Conservatives is that in the late 1970 and early 1980's this party was enjoying electoral success with a message of liberalisation and the benefits of “a return to the market”. Of the programmes written after January 1980, only the Conservatives and Christian Democrats made more than passing mention of the issue area, but none of these two communicated any desire to politicise the issue of reform and a turn to more flexible interest rates. (*Høyres arbeidsprogram* 1981-85:30 and *Kristelig Folkepartis handlingsprogram* 1981-85:13-15). See also Tranøy (1993b:205-206).

⁷⁹ NOU 1983: 29, *Om mål og virkemidler i kredittpolitikken*. The Group was led by Svein Gjedrem from the Ministry of Finance (and who 15 years later was appointed governor of “Norges Bank”. The other members represented *Norges Bank*, the Norwegian Bankers Association and the Norwegian Savings Banks' Association.

that interest rate policy in practice had been less flexible than what *Renteutvalget* and the ensuing national budgets had indicated (NOU 1983:29:11). They also repeated the call for a liberalisation of the bond market as a first step towards a reform of the credit model. The committee also judged the business cycle to be at a stage where the economy could absorb the effects of a lighter touch in the use of credit controls.

It is difficult to gauge the direct impact of this report. But deputy secretary Svein Gjedrem, the man who led the group, was also the key bureaucrat in the Ministry of Finance in the issue of judging the business cycle. It is therefore not surprising that the subsequent national budget agreed with the committee's reading of the state of the economy. Unemployment had been on the rise under non-socialist rule – during 1983 it reached a post-war record of 3 percent - and if expansionary measures were to be undertaken, it was recommended that these were pursued through credit policy.⁸⁰ The vice-governor and by now de-facto leader of the Central Bank, Hermod Skånland, also wanted a possible expansion to be channelled through the credit market.⁸¹

As early as the summer of 1983, shortly after the report was out, the next major step towards actually liberalising credit volumes was taken. At this time the central bank suspended its most severe tranch - conditional loans - a decision the technocrats of the bank were free to make on their own. The main reason this was done, was that *Norges Bank* had just been instructed to keep money market rates down (see subsection 3.4.2). The effect of conditional loans was much the same as supplementary reserve requirements. Both types of controls made banks pay dearly for expanding credit above certain limits. A crucial difference, however, was that conditional loans penalised only banks who made themselves too dependent on central bank financing. As the banks would ignore old norms against making themselves too dependent on short term central bank financing and proceed in building up massive debts in *Norges Bank* a couple of years later (see below), this point takes on further significance with the

⁸⁰ Interview with Svein Gjedrem 17/06 1992. See also Moses and Tranøy (1995:113) and Lie (1998:76).

⁸¹ Skånland 1984, referred to in Lie 1998: 76). At this time the governor of the Central Bank, Knut Getz Wold, was ill, and it is commonly understood that effective leadership responsibilities rested with Skånland.

benefit of hindsight. From January 1984 supplementary reserve requirements were lifted for bank and insurance lending. Further, the bond market was gradually liberalised during 1984-85. Bond investment obligations for banks and insurance companies were lifted, and mortgage companies were allowed more room to place bonds for industrial lending. At the same time the money market was stimulated by the introduction of certificates (NOU 1989:1:108-109).

A brief look at the parliamentary debates in connection with the national budget for 1984 underscores the impression given by the party programmes. These decisions on credit controls were reached within the confines of a technocratic sphere, without any real debate in the democratic channel. Essentially Parliament's finance committee rubber stamped the measures. Labour used the occasion to complain about what they thought were high interest rate levels without linking this to opposition to liberalisation of credit controls.⁸² This might seem surprising because, other things equal, a liberalisation of credit controls in a growing market places greater burden on the rate of interest as a restraining mechanism. That a more liberal regulation of volume presupposed a more restrictive interest policy - or at least not a lowering of rates - was also clearly expressed by the Ministry of Finance inside cabinet when the decision was reached (Lie 1998:78).

The attention received by the 1984 measures in hindsight – after the banking crisis -more than makes up for this however. They have come to be known as *det store frisleppet*. “When everything was let loose” is a fairly direct translation of this term, while idiomatically speaking “the big bank” is probably a better term. Linguistic considerations aside, the leading actors of the day have contested the validity of this description. Former Prime minister Willoch's argument is that supplementary reserve requirements were never meant to be permanent (Willoch 1992). Indeed they had always been switched on and off according to how *Norges Bank* and the Ministry of Finance interpreted conditions in the credit market and the economy in general. According to Willoch the 1984 decision was “a business as usual” type decision, based

⁸² See Budsjettinst. S.II – (1983-84): s.13, 22.

on a shortterm view of the credit market, not a big structural reform. Willoch has also been able to point to the fact that supplementary reserve requirements were indeed reintroduced for a short while in 1986, albeit in a milder form. Citing the contemporary understanding of the leading political, bureaucratic and banking actors of the day, the historian Einar Lie (1998:74-77) lends considerable support to Willoch's position. The "business as usual view" can further be supported by the observation that other instruments from the "old" legislation were retained throughout. The Ministry of Finance and the central bank tried to cool the market with a policy of gradually increasing primary reserve requirements.⁸³

On the other hand neither this typical politician's desire to avoid blame, nor the historian's preoccupation with understanding history "on its own terms", should be taken too far. Such considerations should not lead to the conclusion that the mid-1980's were like any other years in the history of Norwegian Credit Market regulation. One factor that increased the importance of the timing of the lifting of supplementary reserve requirements was that it was accompanied by several other measures that compounded its effect. The stimulus received by the bond and money markets has already been mentioned. Of even greater importance was the fact that restrictions on establishing new branches and offices had already been relaxed to an increasing degree in 1982 and 1983. In particular the savings banks took advantage of this (NOU 1992:30:65). In 1984 concession policy was relaxed further when the three biggest banks were allowed to establish business units in any city or "city-like" places, even in direct competition with the previously protected smaller regional banks.⁸⁴ The combination of new business units and the lifting on credit controls provided a potent mix. Fewer restrictions on the banks aggregate growth can be interpreted as a necessary, if not sufficient, condition for new units to grow at breakneck speed. In the

⁸³ Primary reserves were considered to be more in harmony with the emerging ideal of market allocation than supplementary reserves since it did not punish banks for growth per se, based as it was on total capital and not marginal increases in lending.

⁸⁴ St. meld 23 1986/87, as quoted in NOU 1992:30:65.

two biggest banks, and in several others, that is exactly what happened (Meyer 1992: 165, 173, Lie 1998:31-42).

The more aggressive growth strategies pursued by the banks these years in the mid-eighties can furthermore be related to the effect the reports preparing liberalisation had on expectations towards policy in banking (including central banking) and political circles. Both *Renteutvalget* (in 1980) and *Mål og Virkemiddelvalget* (in 1983) produced consensual and clear recommendations in a liberalising direction.

Renteutvalget's conclusions were understood to have received a general and broad political support. The fact that *Mål og Virkemiddelvalget* was at all established reflects a disappointment that this support had not translated into more specific action. It is also relevant to this debate that even though the Conservative Party had not (as noted above) politicised liberalisation up front, they soon wanted to claim the perceived benefits of it. In 1985 their Minister of Finance, Rolf Presthus, claimed that they were now about to kill off the “cap in hand” situation for customers in one of the few places where it had so far survived, namely in the banks.⁸⁵

The notion that “everything was let loose” at a specific point in time is thus a contested one. One way out of this quandary is to understand the lifting of credit controls as a social construct if not a political decision of the clear cut kind political scientists like to measure political change by: After January 1984 banks started behaving as if credit was no longer regulated. In a behavioural, if not in a strictly regulatory sense, the watershed was a reality. The growth rates these years were phenomenal: During 1985 and 1986 the total assets of Norway's, at the time second largest commercial bank, *Kreditkassen*, grew (nominally) with 124 percent. The biggest commercial bank, *DnC* was not far behind. The gross value of their outstanding loans almost doubled (also in nominal terms) from the beginning of 1984 to mid-1987. At this point, *DnC*, as the first of the hyper-expanders applied the breaks

⁸⁵ St. t. 1985/86:455, quoted in Lie (1998:85) The “cap in hand argument” that is, arguing for liberalisation along distribution of power rather than efficiency lines had been developed in a memo to “Renteutvalget” by its member and then director for the Norwegian Bankers Association, Sverre Walter Rostoft. According to him this argument had some impact on the more sceptical members of the committee. Interview with Sverre Walter Rostoft 26.05.92.

(Lie 1998:254). *Kreditkassen* and *DnC* were not unique in pursuing aggressive growth. That much is evident from statistics on total supply of credit (see subsection 3.4.2 below).

3.3 Boom dynamics

The phenomenon of asset price inflation will be treated in two separate contexts in this analysis. In this chapter, the issue of how assets markets liberalisation was sequenced relative to credit controls and policies impacting the price of credit will be described and analysed in terms of asymmetrical degrees of stickiness. How these two pairs of policies confronted differences in interest structure that made the first pair easier to reform than the second is the subject of the present chapter. In the next chapter (section 4.1) I will attack the problem of asset price inflation and boom dynamics from the angle of selective learning. The point being that the sequencing of these reforms was not only a product of variation in stickiness. The problems that this type of sequencing could lead to were not even on the agenda before liberalisation across these markets was undertaken. This despite the fact that there was ample historical (and to a lesser degree theoretical) evidence available that could have served as a warning of the dangers inherent in letting markets for assets and credit interact in an unchecked manner.

But before proceeding with the analysis of the politics of asset price inflation in terms of either interest structures or learning, a brief introduction to the kind of economic process asset price inflation can release is useful.

3.3.1 Asset price inflation

What then, is the nature of the functional interdependency between markets for assets and the market for credit? This link can be captured with the notion of asset price inflation. The logic is simple. When the assets most commonly used as collateral for bank loans - shares and real estate - go through rapid price increases - this can contribute to bubbles forming in the markets for assets. This is a spiral type movement where rising prices of collateral provide a rationale for extending credits which in turn fuels inflation in these markets, and so on and so forth. Rising prices create optimism

that feeds on itself. Owners of assets can increase their borrowing against objects they already possess and increase their consumption. Or they can invest more heavily in one or both key assets markets, based on an implicit assumption by both bank and customer that the price of the objects in question will continue to rise.

The fire of asset price inflation can be ignited in any market economy with fairly liberal markets for credit and assets. But the immediate post liberalisation phase holds particular dangers because of the one-off effect of catching up, a point which is particularly obvious in the property market. The point is that several decades of severe regulation will tend to open up a gap between the potential collateral value of real estate and the actual degree to which it is mortgaged. In a market regulated the way the Norwegian was, degree of mortgaging reflects historical building costs. Regulations favoured construction and building, not purchases in the second hand market. Historical building costs will over time fall as a fraction of resale value even in a market with moderately rising prices. I do not have relevant data for Norway at this point. There are Swedish data available, however, and Sweden had very similar regulations to Norway in the credit market (Tranøy 2000 forthcoming). Wohlin (1998: 25) points out that in 1985 the total stock of real estate in Sweden tied up around 40 percent of the total stock of loans in the economy. In the UK market which was liberalised earlier, the corresponding figure was around 70 percent. This figure roughly reflects the real estate sector's percentage of total real capital in a modern economy, according to Wohlin. If this is true, the difference between 40 and 70 percent gives us an indicator of the potential for kick-started growth in real estate backed borrowing in an economy moving from tightly regulated credit to a more liberal market order.

In the stock market, a similar catch-up phenomenon can occur. The pre-liberalised stock market of Norway was in general dull, with little price movement either way. This was related to it being ill liquid and relatively unimportant for the financing of industry. In the Norwegian case, as in many others in the post-war era, a gap developed between stock prices and their net realisable value. This sort of gap stimulates asset stripping, but it also indicates a potential for fast paced growth in share prices. Indeed, asset strippers will in themselves have an inflationary impact on the

market as they start bidding up the prices of previously under-priced shares. As late as in August 1983 (after almost a yearlong boom in the share market) Norway's leading broad sheet, *Aftenposten*, presented a set of calculations that are interesting in this context. It's journalists tried to estimate the differential between the share value (as given by the price on *Oslo Børs*) and the underlying realisable value of the assets held by six of the biggest companies on the Norwegian market. The numbers they came up with indicated that the share value ranged from 25 to 50 percent of the net realisable value for the companies in question (Imset og Jacobsen 1985: 48). In other words, limited companies could be bought - lock, stock and barrel - for between half and one quarter of the estimated total resale value of their assets if sold individually.

An important element of asset price inflation is that as it gets under way the realisation that investing in assets with borrowed money can give good short-term returns, spreads in larger and larger circles. People with no previous interest in speculation want to get in on the game. This drives prices further up and creates good profits for earlier entrants. The problem is that when asset price inflation moves beyond the point where it is fed by expectations rather than underlying value, this creates a house of cards like structure. The nature of the downturn can be slightly different in the two markets, as will be discussed below. This should not, however, overshadow the essential point in this argument. Namely that both shares and property markets can become fundamentally unstable when allowed to interact with the credit system in an unrestricted manner, and particularly so when all markets concerned have just moved from a restrictive to a liberal mode of regulation.

The turning point for a market undergoing rapid asset price inflation is of course impossible to predict. Liberalised, computerised and internationalised markets operating to a mode where new information is sought factored into prices before the events the information pertains to have actually occurred, will by nature be volatile and tend to "overshoot!" both ways. In hindsight, however, it is often possible to attach importance to a particular dramatic event or sets of events. Such events create "shocks" that affect confidence in future prices enough to topple the house of cards like structure. Seen from the perspective of an individual country such shocks can emanate

from the results or the failure to honour debt of a particularly important or representative company or from foreign markets. Shocks can be related to raw material prices (in Norway's case oil prices are of particular relevance) or dramatic changes in the political situation and/or policy stance of the country in question. Interest rates increases motivated by exchange rate considerations can start off a downward spiral. High nominal rates will often bring asset prices downwards directly. Sustained high interest rates will also tend to produce disinflation at the retail and wage levels, which in turns contributes to bringing real interest rates (even) higher. This can lead to falling aggregate demand, more business failures and higher unemployment.

When the stock market turns, a lot of people get a strong and simultaneous incentive to get out before others get out, creating a stampede like movement. Consequently you can get a tempo differential between the build up and the crash. First a relatively long boom and then a sharp fall. A cumulative downward movement may well follow this because when banks finance speculation in shares, they normally reserve the right to enforce selling at a given minimum price-level in order to cut their losses. This will easily lead to increased supply of shares on the market in a situation when demand is already weak; thus cumulative effect of actions that seem rational to individual banks may well be to start off a downward spiral. In the market for property the downward cycle will tend to be more drawn out. Most people live in the houses they own, consequently a fall in prices does not lead to the same rush to get out. But as the price of collateral falls credit tends to get more sparse, driving interest rates upwards, curtailing demand for property and creating problems for people who have borrowed heavily, thus more or less consciously gambling on further asset price inflation and/or stable real interest rates. Some households and businesses will be driven into insolvency, and this may again lead banks to enforce sales at low prices contributing further to a negative cumulative movement in the market. If the banks – by default – accumulate large amounts of property on their books, they may be tempted to sell this off in huge blocks in an effort to cut their losses, a practice which may seem rational to the individual bank, but it will also depress prices further.

What happened in Norway in 1984 was that these asset markets were already liberalised and on the rise, ready to soak up borrowed funds when access to credit became substantially easier from 1984. This set off a spiral that wasn't broken until 1987 and 1988 for the share market and the real estate market, respectively. First, in subsection 3.3.2, I will review major developments pertaining to the market for shares. Then, in subsection 3.3.3, I will look at the market for real estate.

3.3.2 The share market – policy and market trends

With the exception of shorter periods of higher activity the Norwegian share market was, as we have already noted, small and ill liquid in the post war period until the early 1980's. On average this market's contribution to domestic supply of credit was around 5-6 percent. In contrast this share had risen to 17 percent in 1987 (Flæte 1997:46).⁸⁶ In line with what one would expect in a credit based financial system (Zysman 1983), equity portions were correspondingly low.⁸⁷ Towards the late 1970's well-organised industrial leaders started arguing for the importance of a better-developed share market as a source of fresh capital and that higher equity portions were needed to reduce the vulnerability of Norwegian businesses. A more pragmatic motive behind this lobbying was that counter-cyclical spending in the mid 1970s had led to increased public recourse to the bond market which in turn had driven interest rates upwards (Imset and Jacobsen 1985: 49). Still, the Conservative party responded to the call of industry and made it its own. They also added a rhetoric similar to the one

⁸⁶ This is a useful indicator, because observations at two different points in time gives a rough measure of change in the relative importance of the share market compared to other sources of finance. The way the term "domestic supply of credit" is used in reference to the figures quoted here is, however, inconsistent with the usage of the term "credit market" otherwise in this thesis. The conventional way of defining the credit market – and the definition I rely on except here – is the following: The credit market consists of the markets for short term papers (money market) bonds and lending from financial institutions. Norwegian statistical tradition has, however, been to include the supply of liquidity from the share market when measuring total supply of credit.

⁸⁷ They continued to be so in small and medium sized businesses while the biggest companies - which were also the most active issuers in the boom period - showed a marked increase in equity portions (Flæte 1997:52).

Conservatives in England were using about “share holder democracy” and the general usefulness of private sector saving and investment.⁸⁸

As was noted in the analysis of interest rate policy above, the 1981 elections produced a majority for the Conservatives and their two allied parties. But unlike in interest rate policy, major liberalising efforts towards the stock exchange were easily pushed through. As early as in 1979, even before they came into power, the Conservatives, with the backing of the Christian Democrats and the Centre party managed to get Labour to agree to the first significant measure. The change was that the lock-in period required to obtain tax exemption on share gains was reduced from five to two years. Only SV voted against this measure arguing that equity portions were “uninteresting from an economic point of view”.⁸⁹

While still in power, Labour objected to introducing tax breaks for investments in mutual funds, arguing that the fiscal consequences would be unpredictable (Bergland 1996:10). On one early occasion, their vice-chairman, Einar Førde also famously ridiculed the optimism with which the Conservatives looked to the bourse.⁹⁰ When power changed hands, however, the non-socialist coalition was in sufficient agreement amongst itself to get a range of new measures through rapidly, and the Labour party did not offer much opposition (Bergland 1996). Among the changes enacted in the Willoch-era was the removal of the ceiling on foreign portfolio investments in Norwegian companies.⁹¹ The non-socialist government also stimulated investments in shares through a substantial reduction in taxes “from both ends” so to speak. It reduced the rate of taxation on share gains (on shares held less than two years) from 50 to 30 percent and raised the lower threshold for tax-exempted gains

⁸⁸ See for example Conservative MP (later to be Minister of Industry) Jan P. Syse’s arguments in favour of introducing tax breaks on investments in mutual funds in 1979. Budsj. Innst. S.I (1978-79):25.

⁸⁹ Budsj. innst. S.I, (1979-80):61

⁹⁰ Using an old Norwegian proverb he compared it to “å bere havre til ein dau hest”, which is hard to translate but it is somewhat similar to the notion of “flogging a dead horse” (Imset and Jacobsen 1985:30). This was said in public speech in 1977, 6 years before the bourse started growing with around 100 percent per year (see below).

twice in two years (Imset and Jacobsen 1985:49-50). Inspired by the popularity of such measures in other countries and in line with their shareholder democracy argument, the Willoch government introduced substantial tax incentives for investment in mutual funds. This measure was implemented the summer of 1982 (Imset and Jacobsen 1985: 50, Bergland 1996:11).

The bourse reacted to this and other stimuli (such as the international upturn that began in 1983) beyond what most people possibly could have expected. A long boom period ensued. In 1983 Oslo stock exchange saw a turnover of 7 billion NOK, a quadrupling from the year before. Industrial shares rose by 122 percent and the all-share index gained 90 percent. In 1984 - the first year of credit boom, nominal turnover grew threefold, to 21 billion kr. This trend continued until the crash of October 1987. If the all-share index is set at 100 at the end of 1982, it was well above the 400 mark by October 1987. Then the market crashed. The index fell well below the 300 mark which translates to a loss of about 40 percent before the end of that year. This fall was much greater than in most other OECD countries (NOU 1989:1:98).

3.3.3 The property market – policy and market trends

The market for real estate was subject to less political stimulation than the share market. Still, it was both politically and economically significant that the first Willoch government (1981-83) gradually liberalised the terms for re-selling co-operative flats. This was an important pre-condition both for the “blue wave” which hit Norwegian politics in the early 1980s, and the boom in the property market that followed in the middle of that decade. Before returning to these decisions it is, however, necessary to present part of the historical and political context for them.

The primary goal of Norwegian post-war housing policy came out of the inter-war crisis and the shortages of the immediate post-war period. This created a lasting concern for providing enough dwellings of an adequate standard. For these ends a

⁹¹ The demarcation line between portfolio and Foreign Direct Investment (that was protected by the concession laws) was set at a 20 percent holding in one company.

strong organisation for housing co-operatives (co-ops) and a state bank for housing were both established in 1946.⁹² This established a three-tiered model for the co-operative sector.

At the lowest tier were individual estates. They owned the dwellings into which members bought a right to rent “their flat”. For most practical purposes – with the major exception of re-selling - this right resembled ordinary ownership. The individual co-op estates were separate juridical entities. Some were members of regional organisations, others were independent. The second tier consisted of the regional organisations. They performed services (such as accounting) for the individual estates but more importantly, they were the main vehicles for developing new projects. To this end they enjoyed privileges with regard to gaining access to municipally developed sites and “Husbank” financing. The third tier consisted of the “NBBL” itself. This organisation performed services for the regional organisations and devoted itself to housing policy at the national political arena.

Housing policy links several policies and distributional issues in a complex pattern. For the purposes of this analysis, however, one problem stands out. That is, the prices in the secondary market for co-operative dwellings. These prices were affected by three separate regulations. Most directly by the level set for the maximum prices as defined by the authorities. These were meant to secure that the subsidy owners of co-op leases had received when going into the market were – in part – to be passed on to the next generation of home-makers. Second, price-levels were affected by rules of first refusal. These rules meant that the co-op as such had to organise a queue according to the duration of the estate/regional co-op membership of the individuals in question. In the independent co-op sector such rules normally did not apply. In reality this brought prices closer to the market level. As long as owners of independent co-op flats had the right to choose to whom they were selling, this choice could and often was, determined by the buying party’s willingness to pay hidden fees directly to the seller. Third, rules of first refusal and maximum prices could be circumvented by co-ops if

⁹² *Norske Boligbyggelags Landsforbund* (hereafter “NBBL”) and *Den Norske Stats Husbank* (hereafter “Husbanken”).

they turned themselves into owner-occupied estates instead. For this reason, legislation in reality made it close to impossible for co-ops to effect this kind of transformation.

In 1977 “Stortinget” passed an amendment to the law on co-ops to make first refusal rules mandatory for all co-ops. This was an effort to overcome the problem of hidden fees. But it also provoked a populist back-lash against detailed regulation of the co-op sector, an ad-hoc organisation was even created (Annaniassen 1996:24-25).⁹³ Home owners who had received what often amounted to a substantial subsidy when going into the market, wanted to be at liberty to realise the market value of their home, and keep the full gains of the appreciation themselves. Until 1977 members in independent co-ops had had an opportunity to realise these values in the black market. The potential for windfall profit was, however, present for a much larger group of co-op owners, independent or not. This was the case in those parts of the country where the maximum price lay below the price one could achieve in a free market, i.e. the biggest cities.

The Conservative Party soon sensed the political rewards of catering to this interest. The promise of reform along these lines, which Labour initially opposed, was most likely a vote-winner for the Conservatives in their highly successful 1981 election. Bay (1985) has addressed this issue. Her data show that support for the Conservatives grew more among owners of co-operative flats than in any other segment in the big cities before the 1981 election. In fact, Bay’s results show that while co-op tenants left the Labour party in droves to vote Conservative, support for Labour was stable among owner-occupiers. Bay (1985:124-125) interprets this as saying that co-op owners had a special affinity for the Conservative’s promise of windfall profits.⁹⁴

Bay’s analysis of Labour’s electoral failure is that it came about because the party assumed a situation where tenure forms were stable and thus constituted a

⁹³ “Aksjon mot tvungen forkjøpsrett” (action against mandatory first refusal) was organised within the framework of “boligselskapernes interesseorganisasjon” an interest organisation for the independent co-ops.

⁹⁴ Both parties had policies that were relatively favourable to owner-occupiers (low interest rates and low real estate tax levels are probably among the more important here).

permanent cleavage. We could take this argument one step further and say that Labour presupposed a society where people were more or less born into co-op tenancy. Where owners of such flats would be solidaristic towards the institution and thus to future generations, while their own potential for wind-fall profits would be less interesting because they had no intention of realising such gains in a market anyway. Rather they would wait for their turn before they moved up in the price-regulated co-op hierarchy. The Conservatives on the other hand had by the late 1970's picked up that there was more mobility in the housing market: Co-op flats were used more as a station en route in a longer tenure-career, the ultimate goal of which was home ownership. In other words, Bay's analysis points us towards deeper structural forces that explain why co-op tenants showed an increased interest in being able to bring their assets to the market. The argument is thus that co-op tenure can be linked to an interest in price liberalisation. As we shall see this interest triumphed. Why it did so will be explained in chapter six.

When the Conservatives came to power they first tried a strategy that can best be described as cunning. They suggested upholding price controls for all but the independent co-ops, but at the same time they wanted to take away all restrictions on their right to transform into owner-occupied estates. This would have provided a powerful incentive for estates to leave the co-op organisations, since it would have been the only route for members to escape price controls and achieve market price for their property. As such the suggestion represented a threat to the whole movement. The Conservatives' non-socialist parliamentary partners opposed the suggestion though, and instead the Willoch-government chose to increase maximum prices with 100 percent on average (Annaniassen 1996:55). Then price controls were phased out and by the mid-eighties the secondary market for co-op dwellings was subject to market pricing.

Moving on to the macro-effects of co-op liberalisation, the pro-cyclical effects to be specific, it is important that liberalisation of prices in the secondary co-op market contributed to all round price increases in the real estate market. In one of the independent commissions set up to investigate the causes of the Norwegian banking

crisis it is argued that abolition of price control in the co-op sector drove prices of owner-occupied dwellings upwards (NOU 1992:30:33). A large amount of households had windfall profits to boost their purchasing power. This meant that many who had formerly been restricted to careers within the co-op sector could now compete for dwellings in the owner-occupied market. While the exact impact of the co-op reform is impossible to estimate, it is beyond doubt that housing prices in general spiralled in the mid eighties. In the three years from the end of 1984 to the end of 1987 second hand housing prices (per square meter) rose by 40 percent in **real** terms. And this was in a period of substantial overall inflation as measured by the consumer price index (which averaged more than 7 percent these years). The market for business property was even more buoyant however. Statistics in this field were not well developed in the mid-eighties, so fully comparable numbers are not at hand. Still, what is probably the best source available indicates that real prices for second hand business property rose by 100 percent from mid-1983 to mid-1987 (NOU 1992:30:33). These developments also spurred a boom in the construction of commercial buildings. The growth rate doubled in these years from approximately 2000 m² per year to 4000m² per year (NOU 1992:30:33).

3.4 The sticky price of credit – nominal interest rates and tax breaks

So far we have seen how the credit market was driven into hyper-expansion by a combination of severely reduced controls and liberalised licensing policy and the strategic choices of the banks themselves. Further, the dynamic but unfortunate interaction between liberalised markets for assets and the credit market has been described. We have also seen that there is some disagreement among commentators as to whether it is correct to speak of 1984 as a watershed, that is, whether it is meaningful to speak of credit controls as being lifted or just temporarily relaxed. What is beyond doubt, however, is that market developments through 1984 were of such a character that measures to dampen credit demand were called for. As it turned out,

however, it was not politically possible to mobilise the price mechanism in favour of contraction before it was too late. Neither the nominal interest rate nor tax breaks were addressed by the actors - the democratically elected politicians - who had the formal power to do something about it.

This was not because leading actors were unaware of the fact that there is a relationship between credit supply and the (after tax) price of credit. The analysis of *Renteutvalget* and the general neo-liberal understanding of the credit market that by now dominated the academic discourse within these issue areas, were entirely clear on this point. The rate of interest - the price for borrowing money - was the instrument one had for regulating the volume of credit when banks felt free to compete for market shares, was the main message of *Renteutvalget's* report. That this was understood, also by the Minister of Finance who presided over interest rate policy through most of the boom period, is not just self-evident it is in fact documented directly. Lie (1998:80) has found a quote which clearly illustrates this. In a discussion of credit supply in the summer of 1985 Presthus stated the following in a memo to the rest of cabinet:

From a technical and economic point of view developments indicate that also credit demand should be sought dampened by making loans more expensive. I will, however, not bring this up.⁹⁵

In the same vein, changes in the tax system were suggested several times in the late 1970's and early 1980's. Vice governor and later central bank governor, Hermod Skånland, even suggested that the relationship between the credit market and the tax system be integrated in the analysis of *Renteutvalget*. He was rebuffed on the grounds that there was a separate commission working on tax policy.⁹⁶ *Norges Bank* also made this relationship a constant topic in their letters to the Ministry of Finance in the 1980's (Skånland 1992:35). The political system was just not able to deliver the changes which conditions in the credit market demanded. In the following two subsections I will describe the laborious processes of achieving tax reform (3.4.1) and interest rate liberalisation (3.4.2).

⁹⁵ My translation.

⁹⁶ Authors interview with Hermod Skånland, 18/06 1992.

3.4.1 Tax reform and the deductibility issue

During the 1970's inflation in it self, and the "bracket creep" associated with it, made the system of unlimited deductions of interest rate charges increasingly dysfunctional. This held true under the social democratic credit regime. But as was soon to be demonstrated in real life, it was even more the case in a more liberal model of credit market management.⁹⁷ Still, credit control and licensing liberalisation and phenomenal growth in credit supply occurred without the political system being able to make headway on this issue. In the story of the opposition against unlimited interest deductions we can distinguish two main phases. As will be discussed in detail chapter six (subsection 6.1.4) these phases can also be associated with different dynamics of inertia. The first phase which began in earnest when Labour sought to put the issue on the agenda in 1977. This phase was characterised by broadly based societal opposition to the risk of losing the privilege of tax breaks. Opposition went all the way into the rank and file of the Labour party and made the issue a very sensitive one for the leadership. The second phase, which can be dated to the early to mid-eighties, saw a different pattern of opposition. The Labour party leadership gradually managed to get the party more truly behind an effort to reform the tax system. The Conservative Party, however, continued to fight for unlimited deductions, thus casting itself in the role of stumbling block until late in the decade.

⁹⁷ Bracket creep is a term used to describe the process whereby inflation interacts with a progressive system of taxation so that lower- to-middle incomes get increasingly higher marginal taxes. This happens when the authorities fail to adjust thresholds in the tax system quickly enough to keep pace with (wage)inflation. Other things equal this type of process, when allowed to happen, increases total government revenue from direct taxation, and it was a widely occurring phenomenon during the 70's. To illustrate with a constructed example: In year y_{+0} a yearly income of 150.000 NOK is within the top 20 percent of incomes and is according to principles of progressive taxation taxed with a high marginal rate, say 70 percent. In year y_{+3} 150.000 is a middle income and should according to the standards of y_{+0} be taxed at a marginal rate of 50 percent. Instead, as a result of the income-bracket thresholds not being appropriately adjusted to inflation an income of 150.000 NOK is in year y_{+3} taxed at a marginal rate of 60 percent. This increase in marginal rates means that middle income families - other things equal - shoulder 10 percent less of their interest rate charges themselves in y_{+3} compared to y_{+0} . On top of this inflation has an independent effect on real interest rates. The total impact of these intertwined processes is of course that they render interest rates a less effective tool for management of the credit market. They also have a subversive effect on credit controls as they contribute to increasing demand for credit through the more expensive grey market.

The first parliamentary initiative to do something about interest deductions appeared in the spring of 1977. The Labour government produced a white paper on the “tax policy and the distribution of income”.⁹⁸ In general terms several weaknesses in the tax system were outlined. The report received broad parliamentary support couched in the same kind of general language. On the sensitive issue of deductions it was spoken of a need to “simplify and limit”, but no specifics were given.⁹⁹ Even so, that same spring, the Prime Minister, Odvar Nordli, felt compelled to stress that his administration had no plans to touch the existing right to make unlimited deductions from taxable income for interest rate charges. This was said to a meeting of party members in his own constituency during the run-in to that autumn’s parliamentary elections. Nordli’s statements demonstrate that Labour was also wary about the electoral costs of tampering with the “right” to unlimited deductions. They marked the start of a more than two-year period of indecision. This period was characterised by leading party figures speaking of the need for reforming the right to unlimited deductions, only for themselves or someone else from the party to backtrack soon thereafter.¹⁰⁰

In the national budget for 1980 Labour tried in earnest again. A framework for tax reform was presented. The key elements as regards breaks on interest rate costs, was to introduce a flat rate tax that would cover all incomes in the biggest incomes intervall from normal to large incomes. This flat rate would be lower than the old average rate. A central point being that a flat tax would produce proportional deductions. (Everyone within the flat-rate intervall would have their taxes reduced by the same fraction of their total interest rate charges). A relatively low flat rate would also yield smaller deductions. To this structure they added a tax calculated from gross income for higher incomes. This meant that they had devised a system that would be progressive that could yield the same revenue as the old system, but without the

⁹⁸ St.meld. 61 1976/77 *Om inntektsfordeling og skattepolitikk*. For the debate on this white paper see Innst. S. nr.226 (1977-78).

⁹⁹ For a summary of the report’s conclusions, see Innst. S. nr.320 (1979-80):14.

¹⁰⁰ Ibid 22-23 where the Conservative Party’s members of the Finance Committee in Parliament give an (unfriendly) account of Labour’s record on this issue.

weakness that higher incomes translated into higher relative deductions. The gross tax would also make it more difficult to become a non-tax payer, or *nullskatteyder*, as the Norwegian term of the time had it.

Labour's representatives tried to argue that the suggested framework was merely putting in concrete terms what had been agreed upon in the broad and general consensus of two years earlier. Even so, the whole framework was killed off in Parliament.¹⁰¹ All parties paid lip service to the need for a wholesale reform, but none supported the suggested framework. The Conservatives, The Christian Democrats and the Centre Party primarily relied on a formal line of argument. They objected to the procedure in that they did not want to commit themselves to a framework before seeing more details. Against this Labour argued that the cabinet needed support for a framework before they could be expected to move on with the details. But the Conservatives also took the opportunity to voice their opposition to most of the content of the proposal. They even described any limits on the right to deduct interest rate charges from taxable income as *damaging*, without backing this up with any further argument.¹⁰² To the left of Labour, The Socialist Left Party, argued that the framework did not go far enough, in that it only dealt with inequalities generated by the system for wage incomes, while the taxing of self-employed and businesses was left untouched.¹⁰³

Roughly a year after this rebuff, the Labour government, now lead by Gro Harlem Brundtland, instigated a broad-based commission of inquiry to look at personal taxation in general (i.e. including both taxation of wage-income and self employed). This committee delivered their report, complete with suggestions that could be implemented "immediately" - i.e. without changing the present laws - in the spring of 1984. One of these immediate measures was - as Labour had suggested in the national budget for 1980 - to reduce progression on net income and shift some of the burden over to gross income. This would have given an immediate and substantial increase in

¹⁰¹ Innst. S.nr. 320 (1979-80). Labour's group in the Finance committee put forward the following reflection: *The Labour party notes that it is as easy to win support for the notion of a new and more fair tax system, as it is difficult to reach a decision on the changes this presupposes.* (p.14).

¹⁰² Ibid p.22

¹⁰³ Ibid. p.47

real post-tax interest rates. At the time marginal tax rates on net income for high-income groups hovered around the 70 percent mark. If we disregard the effects of inflation (which brought real rates further down) this meant that a 1 million kr. loan carrying a rate of interest of 10 percent, represented an actual annual cost of 30.000 NOK for high-income borrowers. The remaining 70.000 NOK, would be recouped in lower taxes. In this example the effect of a reduction in the marginal tax on the net income of this individual from 70 to 50 percent would be to increase his interest rate costs from 30.000 to 50.000 NOK. To achieve the same effect on this person's cost of borrowing through nominal rates, they would have had to be raised from 10 to more than 16.5 percent (given an unchanged tax system)!¹⁰⁴

The Conservative leader of the bourgeois coalition government, Kåre Willoch would not act on the suggestion of introducing gross tax. In his memoirs Willoch (1990:310) argues that solid Norwegian traditions dictated that the committee's report was given a public hearing before anything was decided upon. Three years work from a broad-based commission that counted members from all the major parties and parts of business, was not enough for even the suggested immediate measures to be considered. While Willoch's quasi-constitutional concerns may well have been heartfelt, he undoubtedly also had pressing electoral concerns. Lie's analysis (1998:85) is probably astute.¹⁰⁵ He argues that the Conservatives had, with some success, profiled themselves as the party of the taxpayers. While their bourgeois partners in Government had invested little in the tax issue and could probably have been moved towards some kind of compromise, this was not the case for the Conservatives. This party was haunted by an infamous promise made during their successful 1981 electoral

¹⁰⁴ This is a stylised and simplified example constructed in order to illustrate how enormously important tax rules were for credit policy at the time the boom got under way in 1984. More sophisticated calculations based on real data for the economy a few years later do also exist, however. It has been calculated that for 1986 real post tax rates to have reached the level these rates had after tax reform in 1992 (around 7 percent, with a flat marginal tax on net incomes of 28 percent) nominal rates would have had to have been around 30 percent. That is, in stead of almost 16 which they averaged that year. Part of this differential is of course due to the fact that inflation was higher in 1986 than in 1992. Still, the bulk of it reflects the value of unlimited deduction of interest rate charges for average incomes (NOU 1992:30:84).

campaign. The promise was to slash taxes by 7 bn. kroner, but they were never able to keep it. This is the background why Kåre Willoch was worried about anything that could connect his party to higher taxes. To this we might add: In particular higher taxes for well off home owners, his core constituency. As we shall see in chapter five tax reform was not begun before Labour took over the executive and a shared understanding that Norway was entering an economic crisis developed through the second half of 1986.

3.4.2 Interest rate controls

Compared to the issue of interest deductions, there was something of a role reversal between Labour and the Conservatives on the issue of interest rate controls. At least in opposition Labour was a champion of non-reform, fighting for lower rates. They even continued to do so even as the market was taking off while supply side controls were either largely ineffective or scrapped. The role reversal was not complete however. The Conservatives might have been less enthusiastic than Labour about *cutting* interest rates, but they never assumed the role of championing reform. In other words Labour championed tax reform with increasing conviction, while the Conservatives were the least recalcitrant party as regards interest rate controls. This means that in interest rate policy the most important fault line continued to run between elected officials on the one hand and technocrats on the other, until reform was secured. That is, until the onset of current account and currency crises in 1986. By December that year democratically elected politicians caved in, en bloc, and interest rates were handed over to *Norges Bank*, for purposes of defending the value of the currency.

In the following I will run through the chronology of the main events concerning interest rate policy. Around 1977 cartel-like deals on deposit rates started to break down in earnest in Norwegian banking circles and competition became more prevalent than co-operation. This happened before the market for deposit rates was

¹⁰⁵ Hanisch (1996:199) also singles out the Conservatives as the main block to tax reform in the mid-eighties.

formally liberalised in 1983 (Espeli 1995:131-135). On the issue of lending rates the sequencing between formal liberalisation and actual market pricing was in a sense opposite. As will be shown below. It was not until 1985 that rates on loans to the public were formally liberalised. But several more years passed before Governments gave up pressurising the banks for lower lending rates. This development reflects that both Labour and Conservative/non-socialist governments of this period were happy to see that the public could get better returns on their deposits. At the same time, however, one wanted to protect the public in their role as borrowers. In terms of the banking crisis that was to follow, the asymmetry between lending and deposit rates also had interesting consequences. It meant that a structural pressure on bank's margins that would have come as a result of increased competition anyway, was for a crucial period made worse by policies driven by electoral concerns.¹⁰⁶

Norges Bank had been hoping that the change of Government from Labour to the Conservatives after the elections of 1981 would lead to a more flexible use of interest rates for macro economic purposes. They made concrete suggestions as to how interest rates on government bonds should be set, but the central bank was rebuffed by the Finance Minister in no uncertain terms (Skånland 1992:34). What Willoch's two governments chose to do, was to hide behind the concept invented by *Renteutvalget* in 1980, that of "estimated equilibrium rate". I use the verb "hide" because they never practised interest rate control with the kind of flexibility the notion of "estimated equilibrium" suggested. Instead so-called *renteerklæringer* (political decrees about the appropriate level for the rate on loans to the public) were issued. As regulatory instruments, *renteerklæringer* were functional equivalents of the so-called *rentenorminger*, which had been in use until 1977. The novelty of the 1980's version was that interest rate regulation was not only lagging behind, now they were

¹⁰⁶ Johnsen (1992:56) argues that regulation like the one Norwegian banks were subject to in the period from 1950 to 1980 creates cartel-like conditions and thus he expects increased competition to be accompanied by reduced margins. Espeli (1995) documents the first part of this argument historically. His study shows how public regulation and industry-internal regulation/co-operation interacted in the period from 1950 to the late 1970s, with one of the results being lower deposit rates than what would otherwise have been the case.

increasingly going against current market conditions: As demand for credit increased interest rates were actually decreased.

Around the time of the 1983 municipal elections the Centre Party and the Christian Democrats decided that they wanted to join Mr. Willoch's government rather than just providing its parliamentary basis of support. The Centre party ministers came to their new roles with an agenda regarding interest rates. During its annual conference earlier that year the party had reached a decision to work for a lowering of rates. As soon as the new Government was installed, the Ministry of Finance began to instruct the central bank to keep the money market rate within a narrow, and compared to previous years low, band to underscore their policy of low interest rates. Meanwhile, from the outside, Labour kept pushing for lower rates. As mentioned above, they did this in parliament when the 1984 lifting of credit controls was decided upon, and in particular before the 1985 general election. Willoch's own analysis (1990:308, 1992:69) is that this created an enormous pressure on him and his government. Labour's clamouring for lower rates made it electorally very costly for his coalition partners to be associated with anything else.

Given what we now know of the boom and bust sequence, it seems close to incomprehensible that so many from Norway's political elite were fighting for lower rates at a time like this. Hindsight and contemporaneous concerns are two different perspectives, however. What these people were reacting to was the fact that by post-war and international standards both unemployment *and* nominal rates were high in the mid-eighties. In 1983 unemployment averaged more than 3 percent. This is a minuscule figure by most standards, but not compared to the Norwegian post-war record until then. The same year the average nominal rate from banks on medium and long term lending was 13.8 percent. All through the post war period until the late 1970s nominal rates had been measured in single digit figures. Inflation was coming down in the early eighties and marginal tax rates were somewhat reduced. This resulted in real post tax rates creeping towards zero, while they had been negative throughout the inflationary 1970's (NOU:1989:1:110 table 5.6).

Kåre Willoch (1990, 1992) the one politician to write systematically about credit policy in the mid 1980s, insists that he as Prime minister, tried to stop interest rate reductions. Thus he holds his own illness between Easter and Pentecost in 1984 as crucial for why there was a *renteerklæring* reducing rates with half a percentage point almost as soon he returned to his post (1990:308). This implicates that his own Minister of Finance, Rolf Presthus was less able to resist pressure from the coalition partners. Willoch, in fact, can be interpreted as saying that Presthus actually agreed with those who wanted lower interest rates (Lie 1998:78). This is less surprising if one takes into account that the Conservatives also had a profile as a party of homeowners to cultivate. Furthermore, a review of the party's programme for the 1981-85 period reveals no desire to communicate to voters what a more liberal credit market regime might entail in terms of interest rate policy.

When it finally happened in September 1985, the abolition of standardised interest rates at the *retail level*, appeared as a half hearted measure. This was because the newly established practice of keeping the money market rate down was continued, while interest rates were to be under "continuous surveillance" (NOU 1992:57). Against the central bank's wishes, it was instructed to move the *money market band* further down in an effort to minimise the effects of liberalisation for customers (Hanisch 1996:199). In a statement to the latest commission to report on the banking crisis, the then governor of *Norges Bank*, Hermod Skånland, said this was necessary to secure political support for the reform (Dokument 17:35). This demonstrates that the Central Bank was willing to implement policies that it disagreed strongly with in order to protect the larger liberalisation process. To this picture it should be added that the Central Bank was not at its strongest in terms of political influence at this time. Its prestige was weakened by a public debacle over cost overruns at its new main building, and there are also indications that the political leadership of the Ministry of Finance did not hold the bank in high esteem.¹⁰⁷ As we shall see in chapter six the importance

¹⁰⁷ Lie (1998:90) makes this observation. He also refers to an indicative remark made by the Minister of Finance, Rolf Presthus in 1983 regarding a regulation introduced that year: "The measure has also been recommended by the Central Bank, not that this has been decisive for my judgement".

of the bank as a provider of policy advice was to increase dramatically when economic policies were tightened late in 1986.

The exercise of conducting pro-cyclical interest rate policy through the money market did turn out to be extremely demanding in terms of the amounts of central bank liquidity it took. The reason for this was related to the fate of NOK. When bank lending started to really grow from 1984 and onwards, banks had taken the opportunity to borrow short term in the currency market. Norway's capital controls were not formally lifted yet at this point. But in 1978 a rule had been introduced which in the circumstances that held sway in 1984-85 turned into a loophole for foreign funds. The rule demanded that banks balanced currency debts with futures contracts to buy currency. This way banks would be able to hedge against currency risk when exchanging oil revenues from dollars to NOK, without opening the Norwegian market to foreign funding as such. *Norges Bank* calculated that the price the banks would have to pay for these forward contracts would make it less tempting to seek funding abroad, even if Norwegian nominal rates were higher than those paid in the international market. By 1984-85, however, circumstances had changed, and the rule proved to have dramatic unintended consequences.

The combination that yielded these circumstances was the lifting of credit controls, a currency under upward pressure and the differential between nominal and post tax interest rates in Norway on the one hand, and the difference between Norwegian and foreign rates on the other. The lifting of credit controls made it possible for banks to expand at break neck speed, legally. The strong NOK minimised the currency risk involved in having assets in NOK and liabilities in foreign currencies, thus the price of forward contracts fell. High nominal rates in Norway assured the attractiveness of foreign funds to the banks. The difference between foreign and domestic rates translated into a direct profit. At the same time low post tax rates contributed to keeping domestic demand for credit sky high. In 1984 and for most of 1985, this kind of borrowing was feasible, if not advisable, as the Norwegian krone

was under pressure to appreciate.¹⁰⁸ *Norges Bank* During 1985 the amount of primarily short-term funds secured from abroad was 22 bn. kroner, which amounted to 40 percent of growth in lending that year (Dokument 17:39).

When the oil price fell dramatically around new-year 1986, this picture changed. The currency market started to speculate against the NOK. This meant that the government's instruction to the central bank to keep money rates down translated into periodically massive infusions of liquidity from the central bank to the banking sector. The central bank had to do this to avoid increasing money market rates as Norwegian banks could no longer find takers for their currency deals in the forward market. The sums required to sustain this policy were truly huge. At the beginning of 1986 central bank funding of the banking system was negligible. In May 1986 immediately before NOK was devalued, short term borrowing and re-purchase agreements totalled a staggering 90 billion NOK. The figures fluctuated throughout the year, but stabilised at around 60-70 billion towards the end of the year, and remained at that level for several years to come. If we compare the size of the previous inflow from abroad with the amount of central bank lending that took place now, this tells us that central bank funds not only replaced foreign money. Bank's coffers were actually also replenished through this process (Dokument 17:41).

As a consequence the incredible credit expansion kept up its momentum. Overshooting compared to the national budget reached 50 percent in 1985 and more than 100 percent the next year, with 1987 not far behind 1986 (NOU 1989:1:table 4.1). The latest report on the banking crisis concludes that the part of the funds that went to replace foreign funding at times of acute crises for NOK, can be seen as a function of the central bank's role as lender of last resort, and was thus driven by systemic imperatives. At the same time the commission behind the report concludes that if the "remaining" demand for central bank funding had been met by higher interest rates the

¹⁰⁸ The situation in 1984 and early 1985 also illustrates the dilemmas more open currency markets can create for monetary policy, since hiking Norwegian rates could have strengthened the NOK and stimulated the import of funds even further. Given the prevalent political attitude vis-à-vis interest rates this was not a feasible option, but the dilemma was never-the-less reflected upon in *Norges Bank*. Interview with Hermod Skånland (09.02.2000).

credit boom would have been intercepted at an earlier point, and the subsequent crisis less severe (Dokument 17:40-41). In hindsight we can see that this means that the political wish to control interest rates through keeping money market rates down, was an important precondition for the crisis to become as deep as it subsequently did. The policy of regulating money market rates downward was unfortunate and misguided.¹⁰⁹

Both Willoch's governments and their successor from May 1986, a Labour government lead by Brundtland, were determined to avoid as much as possible of the political costs associated with liberalisation.¹¹⁰ This is evident in the way the strategy of forcing the central bank to subsidise the money market was followed up with a practice that can be described as "bank bashing". The policy of "continuous surveillance" in effect translated into highly publicised, but according to bank-sources insubstantial, meetings with representatives of the banking sector. Both before and after money market rates had been allowed to rise in order to defend the currency, Presthus and Berge, Ministers of Finance for the Conservatives and Labour respectively, urged the banks to show "moderation and not greed". The meetings were media-occasions and the politicians took these opportunities to assure the public that the rate of interest was watched continuously. According to participants from the banking side, these meetings were in effect tools in a public relations war. This contributed to aggravate already poor relations. Consequently the ability to have a constructive dialogue over other problems of the day was poor. I will return to the significance of state – bank relations in chapter four (in subsection 4.5 in particular).¹¹¹

¹⁰⁹ This emphasis on the policy set by democratically elected politicians, rather than focusing on (poor) judgement on the part of the central bank is in agreement with the conclusion of the commission (ibid.17:42).

¹¹⁰ The changeover from Willoch to Brundtland in May 1986 is returned to and dealt with in more detail in chapter five (subsection 5.1)

¹¹¹ During my interviews with former CEOs of big banks (and at different times NBA chairmen) such as Egil Gade Greve (Bergen Bank) and Tor Moursund (Kreditkassen) and Trond Reinertsen former NBA CEO, - Interviews done 12/6 and 16/6 and 27/5 1992, respectively – I got the impression that banking sector representatives felt stabbed in the back by the attitude taken by the Ministers and their top aides at this juncture. The argument would be that they had all agreed on the need for a more market based rate of interest, but that when push came to shove and the public

Norges Bank contributed too pressurising the banks, too. Not because it wanted low or lower rates per se. Its motive was fear of a political backlash against what had already been achieved in terms of liberalisation. This transpires from Lie's analysis of internal documents from Norway's biggest bank, *DnC*. Reports from meetings between top management in the biggest banks and Governor Skånland from *Norges Bank* reveal that the central bank appealed to their joint long term interest in not seeing liberalisation of credit and interest rate controls reversed. *DnC*'s CEO, Leif Terje Løddesøl, was also left with the impression that *Norges Bank* was concerned about lending growth, but not as concerned as the numbers perhaps could have led him to expect (Lie 1998:95). The political pressure paid off. Nominal rates hardly changed at all from 1984 to 1985.¹¹² And the banks themselves have indicated that they felt restrained by the climate created by politicians, joined by the media and consumer watchdogs (NOU 1992: 30:57). All this occurred while market conditions clearly called for price increases. Lie (1998:95-96) says that as late as in 1988, at a time when *DnC* were in obvious financial distress, the bank felt pressurised by the MOF to drop an interest rate increase they had given notice of.¹¹³

3.5 Sustaining the boom: fiscal and incomes policy

As stated in the introduction, fiscal and incomes policies will not be discussed in the section devoted to theoretical interpretation that follows below. I have not defined them as central enough to the reform efforts that I primarily want to understand. There are, however, two reasons for including these policies at this stage

suddenly faced higher rates the MOF wanted the banks to take all the blame for what was happening. See also NOU 1992:30:57.

¹¹² Average nominal rates charged by banks in 1984 was 13.3 percent, the corresponding number in 1985 was 13.4 percent (NOU 1989:1, table 5.6).

¹¹³ I have not conducted research that allows me to conclude with certainty that this kind of pressure is not used any more. But the general impression from following politician's reactions to the pricing policy of banks, is that the crisis has greatly increased sensitivity to the importance of banks operating on sound margins. In NOU 1992:30:57) it is stated that banks were free to set their own prices from around 1988. The most important indicator here is probably the difference between

of the narrative. Firstly, they form part of the broader political economic context of the phenomenon under study. Neither of these policies were accommodated fast enough as the boom was taking off, the result being that they compounded the co-ordination problems that riddled Norwegian economic policy in the mid-eighties. The second reason for introducing these two issue areas now is that they form part of the background for my discussion of when the boom was registered and how it was interpreted by the economic policy making milieu. These are topics that will be returned to in the chapter on selective learning.

From the outset in 1981, Conservative fiscal policy was relatively tight. The image of the twin deficits of the late 1970's was still informing policy in the Ministry of Finance and in the executive. Even though unemployment rose through 1981 and 1982, and both deficits were "taken care of" by increased oil revenues, this position was maintained. The local elections of 1983 proved to be a turning point for the economic strategy pursued by Mr. Willoch. Particularly the Conservatives, but also their supporting parties in parliament, the Christian Democrats and the Centre Party, were disappointed with their results in these elections. Unemployment was on the increase and it was unevenly distributed geographically. There was close to full employment in the big cities, with higher rates in several of the peripheral districts that are part of the heartland for the Christian Democrats and the Centre Party (Mjøset 1986: 254). This was interpreted as a warning. The two allied parties joined the executive, still under the leadership of Mr. Willoch, and a more expansionist economic policy gradually took shape. The choice of 1984 for loosening credit controls was informed by the desire of the new coalition government to stimulate the economy.

Fiscal policy in 1984 was moderately expansive, as measured by a *structural budget balance* indicator (NOU 1992:30:60-61).¹¹⁴ An important point here, however,

lending and money market rates. Only during 1988 did the Norwegian market see the emergence of a healthy margin of two to three percent here (NOU 1992:11, figure 1.1.2 A).

¹¹⁴ What indicators that best capture the impact of fiscal policy on aggregate demand is an ongoing debate in economics. The indicator I have referred to as the structural budget balance is commonly used in budgetary documents in Norway in the 1990s. The logic behind constructing such an indicator (in stead of just looking at the public sectors balance sheet in pure accounting terms) is, roughly speaking, a desire to leave out the effects of cyclical changes on the budget balance.

is that policy for 1984 was formulated against a background where the Ministry of Finance underestimated several expansionary impulses that hit the Norwegian economy from the autumn of 1983. First of all one was late in seeing that an international upturn was under way. Secondly the prices paid for and the size of the demand from North Sea investments towards domestic producers was underestimated in the planning documents.¹¹⁵ In 1985, the second year of the boom - and the year of a general election - fiscal policy got very expansive (NOU 1992:30:61). The dynamic that played itself out was predictable. There was a three-party coalition with different expenditure priorities and high oil incomes to draw upon. To compound matters an opposition fired by the recent unemployment record was barraging the coalition from the outside with claims that the welfare state was in danger.

During 1985 finance minister Presthus fell into line with his senior officials and wanted a more restrictive stance. Before the 1985 elections the Willoch-government had produced a budget for 1986 that was far too expansionary in his judgement. He proposed to tighten it with 3 billion NOK, mainly through cutting expenditures. A committee with representatives from all three parties sat down to review the suggestions. Cabinet internal documents studied by Lie show that the final result was a loosening of the budget by a further 227 million NOK. Lie, who is also the Ministry of Finance's historian (Lie 1995), doubts whether a Norwegian Minister of Finance has ever suffered a comparable defeat (Lie 1998:82). Presthus decided to stick to his post, but signed the final budget with an infamous remark that others had a hand on the pen he used to give his signature.¹¹⁶

Examples of such cyclical elements can be changes in unemployment benefits and taxes. By eliminating these elements the impact of structural changes in the fiscal stance can be gauged. The structural budget balance can be calculated according to different principles, but the one I have chosen to refer to throughout this thesis is *olje- aktivitets- og rentekorrigert overskudd* (a direct translation could be: oil-, activity-, and interest rate corrected surplus. This indicator seeks to "cleanse" the budget of the impact of the oil sector, of interest rate payments to and from Norway, and the impact of expenses and incomes that vary with the business cycle. In chapter five (section 5.2) we shall see that the validity of this indicator has been challenged.

¹¹⁵ Interview with Svein Gjedrem 17/06 1992. See also Steigum (1992a:38) and Rødseth (1995:176).

¹¹⁶ Presthus' actual choice of phrase in Norwegian was that he was signing *med påholden penn*.

This is a good story, but it tells us more about the political dynamics of the last Willoch government, than about fiscal policy for 1986. After the “reverse oil price shock” of the winter of 1985-86, the Willoch cabinet agreed to tighten fiscal policy after all. In the process it demanded a vote of confidence on a relatively small increase in indirect taxes. It lost the vote only to be replaced by a Labour government that went on to tighten fiscal policy itself. Measured by the structural budget balance, the end result was a tight fiscal stance for 1986 (NOU 1992:30:63, see also chapter 5). Keeping in mind that a change in fiscal policy takes its time before working its way through to actual economic behaviour, it is probably fair to say that this tightening came too late to influence the boom which peaked in 1986 anyway.

Wage settlements on the other hand arguably has a more immediate impact. Both through generating more easily calculable expectations, and in terms of the time lag between actual settlements and cash in hand for the salaried classes. The wage settlement of 1986 certainly did not help matters as regards inflation. After a bitter conflict it culminated with a lockout that ended with a grand defeat for the employers association and an agreement to reduce working hours for industrial workers - fully compensated. This translated into the most expensive settlement since the still talked about settlement of 1974.¹¹⁷ This and the falling oil prices gave rise to strong speculation against the NOK and the incoming Labour administration devalued by 10 percent almost immediately.¹¹⁸ The devaluation provided further inflationary impulses. Imported goods became more expensive, and as a consequence of this demand shifted towards domestic production, a sector that was on full capacity already. There were also clear signs that Norwegian exporters took the opportunity provided by the devaluation to increase their prices in NOK, rather than seeking to win back market

¹¹⁷ Table 1 in Høgsnes (1995: 12). See also Erichsen (1999: 147). The booming economy in general and labour market in particular, and a totally failed strategy on the part of the employers union (which lost their long standing CEO, Pål Kraby, his job and sparked a restructuring of the whole organisational landscape of capital in Norway, is part of the picture explaining the settlement of 1986.

¹¹⁸ See chapter 5, section 5.1.2 for details.

shares.¹¹⁹ The rate of inflation, which had shown a downward trend for 5 years, being halved from 1981 to 1985, picked up again. It went from 5.7 % in 1985 to 7.2 % in 1986 and 8.7 % in 1987, thus nudging the real post-tax rate of interest downwards, even though these years saw increases in nominal interest rates and cuts in marginal tax rates (NOU 1989:110, table 5.7).

At this point the narrative on asymmetrical degrees of stickiness ends. But even the stickiest of policies – i.e. tax breaks and interest rate controls – came unstuck, eventually. The story of how these issues found their resolution under the weight of a foreign economic crisis is told in chapter five. I will not stop to conclude the present or the next two chapters separately. Instead local conclusions for chapters three through to five are collected in chapter six. In section 6.1 then, the case materials presented above are confronted with the propositions developed in chapter two. I will analyse how the structure, mediation and perception of interests determined the degree of stickiness with which the different policy areas were reformed. This is done in an effort to develop a theoretically informed explanation of the events described above.

¹¹⁹ Norwegian export volumes in traditional goods went down from the second to the third quarter of 1986, while export prices increased (“Økonomiske Perspektiver” in *Penger og Kreditt* 4/1986:379, as quoted in Hanisch et. al 1999:320).

Chapter 4: The boom years – pervasive underestimation as a function of selective learning

This is the second of two chapters that discuss the politics and policy of the boom period. Both chapters are empirical and descriptive in nature. The division of policy areas between them is analytically motivated. In the preceding chapter those policy areas deemed to be subject to the logic and consequences of asymmetrical degrees of stickiness were discussed. But reform policy is not just about decision-makers grinding out results in one policy area after another in a sequence decided by the matrix of support and opposition they are confronting. In hindsight we can see that it is also about ignorance and information. This chapter seeks to map empirically how selective learning left planners and decision-makers unprepared for important, and arguably, foreseeable consequences of their actions. If the risk of financial instability that liberalisation entailed had been better understood this could have led to more stringent precautionary policies and better risk management in the banks themselves. It may even have lead to stronger attempts at overcoming the logic of asymmetrical degrees of stickiness This chapter will show that cognitive limitations hampered governance throughout the liberalisation process. This is evident firstly from the way that what turned out to be key problems were not even on the agenda when the process started. And secondly in the way the cognitive framework of the technocrats impeded their ability to comprehend what was going on after the process had been set in motion.

The discussion is organised in four sections. The first two sections deal with lack of risk awareness at the level of the system and the individual institution respectively. Section 4.1 takes an historical approach and discusses the rise and fall of asset price inflation and financial instability in the consciousness of Norwegian technocrats and decision-makers. In section 4.2 with subsections, I investigate how the management of risk at the level of individual institutions was neglected at different levels of policy making and different stages of the liberalisation process. The two next sections deal with insufficiencies in how the boom was interpreted and dealt with. Subsection 4.3 tells the story of how the magnitude of the boom was partly

underestimated, and partly “explained away” by actors seeking to interpret it primarily as a statistical artefact, not a real phenomenon. Subsection 4.4 describes the few policy decisions that were after all made in an attempt to curb the boom, and it discusses why the most important of the instruments used probably had a paradoxical effect given the market conditions that held sway in the middle eighties.

The division of labour between empirical narration and theoretical interpretation between the chapters follows the model from chapter three. That is, in chapter six I will return to the findings made in the present chapter and interpret them in light of the theory presented in chapter two.

4.1 Underestimating system level risk

Chapter three showed us how asymmetrical distribution of stickiness between the issue areas involved helped produce a policy mix that more or less invited asset price inflation and financial instability. But it is also worth reflecting on that the problem of asset price inflation and the risk of interaction effects between the markets for credit and assets was not even on the agenda, before or during liberalisation. This means that asset market and credit liberalisation were never seen in context of each other. The field was left open, so to speak, for the logic of asymmetrical degrees of stickiness to play itself out. There were no political initiatives seeking to adjust the sequencing of these reform projects. Old lessons on the dynamics of financial instability were ignored or forgotten all together. This marks a contrast to the level of awareness one can find regarding the relationship between credit controls and policies that impacted the cost of borrowing (e.g. interest rate controls and deductibility rules). As we saw in section 3.4, the functional interdependency between credit and interest rate controls was the centrepiece of the analysis of *Renteutvalget*. The importance of tax rules to this relationship was also clearly understood by key actors. Unsuccessful attempts at tax reform were also made before the credit market was liberalised.

Since the argument I want to make here is about lack of awareness of the dangers of asset price inflation, this section could be very short. I could simply state that the report of *Renteutvalget* ignored the potential for such a problem when

discussing the effects of a more liberal system for allocation of credit. The closest the report came to this issue was to discuss if changes in monetary policy could be expected to have any real effects at all, or whether it would only affect price levels (NOU:1980:4:123-127). Financial instability and its potential for (very) real consequences was simply not an issue. Furthermore we can note that this problem was not perceived from the other side of the fence either. In the debates on liberalisation of the stock and housing markets, these were merely seen as supply side measures. Liberalising these markets was talked about in terms of improving equity portions and share-holder democracy (as regards the stock market) and distribution and self-determination (as regards the housing market). To my knowledge the issue of asset price inflation was not brought up anywhere before it was obvious, after the fact.

I will, however, not leave it at that. In stead I will make an effort to demonstrate that in Norwegian technocratic circles in the early pre-war years there was a manifest awareness of system level and macro-economic risk. The generation that came to power and influence immediately after the turbulent inter-war era realised the dangers to the real economy that a spiral movement originating in excessive bank lending entailed. I will also point out that throughout the post-war era substantial contributions to the study of financial instability were being made by economists working in a less celebrated part of the tradition after Keynes. This argument is not made in order to have an academically acceptable pretext to gloat. It is made because the presence of available but not utilised knowledge is what makes it meaningful to speak of selective learning.

As early as in 1898 the Swedish economist Knut Wicksell formulated key insights into the danger of cumulative interaction between unfettered credit markets and markets for goods and assets. This later brought him fame, and his insights were expanded upon by the leading Norwegian economist and founder of the “Oslo-school”, Ragnar Frisch who among other improvements included labour markets as a variable into this kind of analysis (Andvig 1991). In general, the different economic milieus that in the 1930’s all argued for countercyclical spending as a remedy against recession shared an interest in disequilibrium economics.

A concrete example from a Norwegian setting is to be found in this quote from a group established by the Norwegian Labour party in preparation for the general election of 1949. The group's mandate was to look into what would constitute appropriate policies towards the banking sector.¹²⁰ An important member of this group was the Minister of Trade, Erik Brofoss, who had already served as Labour's first minister of Finance of the post war period, and was to become the next central bank governor.¹²¹

Banks pursuing their self-interest can to a large degree worsen a crisis through overzealous restrictions on credits, without concern for the needs of industry and working life. When the banks, as during the previous world war, driven by competition and a desire for profits have supported speculation and unhealthy business activity, their weak powers of resistance can easily lead to bank closures with a further deepening of the ensuing crisis.

Later in the same document the group drew this policy implication:

It is of the utmost importance that necessary steps are taken to prevent that the banking system can again act as a mainspring for great cyclical movements and the devastation this brings.

As we have seen, in the 1950's and 1960's a veritable arsenal of policy instruments were developed so as to ensure that the banks would act more in "the interest of industry and working life" and to prevent them from again becoming "mainsprings for great cyclical movements". In 1947, while still Minister of Finance, Erik Brofoss defended the institution of national budgets in terms that reflected optimism in the struggle against violently swinging business cycles. He also emphasised that this demanded great efforts of co-ordination on behalf of the state, and in the process revealed a strong technocratic ethos:

Mankind has through scientific and technological progress managed to free itself from the tyranny of the elements....It would be a step towards greater freedom if we could free ourselves from blind submission to the accidental circumstances of economic life, which to the individual must appear as forces of nature. We must try to master the elements of the economy, in stead of being mastered by them. To achieve this we need a purposeful and planned co-ordinated economic policy.¹²²

¹²⁰ Frihagen Anders, Brofoss Erik et. al.1948: *Bankvesenet i Norge, Innstilling fra en av Sentralstyret nedsatt komité*. The quoted passages are from pages 7 and 20 respectively. Author's translation.

¹²¹ When Brofoss became Trade Minister in 1947 he also took the work with the national budget with him. The functional argument for this was that immediate post-war shortages created a need to ration imports. His tenure at *Norges Bank* lasted from 1954 to 1970.

¹²² St. tidende 1947:1997 as quoted in Lie (1995:100).

John Maynard Keynes, the economist whose name has come to be associated with the successful effort to counter neo-classical orthodoxy in the 1930's, went beyond restrictive assumptions of rationality when speaking of assets markets. He observed behavioural traits that are more commonly associated with social psychology than with economics. He was quite clear on how financial markets could be destabilised by a dynamic where deficient information, herd mentality and attention to the expectations of others were more important to financial market development than what was going on in the real economy (Keynes 1936:315-316):

It is of the nature of organised investment markets, under the influence of purchasers largely ignorant of what they are buying and speculators who are more concerned with forecasting the next shift in market sentiment than with a reasonable estimate of the future yield of capital-assets, that, when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force.

In the first 30 to 35 years of the post war period, research on financial instability was confined to the margins of mainstream economics. It was conducted by men, who like Keynes, but unlike his mainstream successors, were interested in economic history and the institutional underpinnings of a market economy. The three most well known were Americans. John K. Galbraith (1955, 1975) Charles Kindleberger (1973, 1978) and Hyman Minsky (1964, 1977), have all contributed to our understanding of the anatomy, causes and consequences of speculative booms and subsequent crashes. But it is probably fair to say that this research and the insights it yielded were part of the dominating debates in neither academic nor policymaking circles. In Norway concerns about financial instability more or less disappeared from both policy documents and academic debate between 1950 and until the crash of the late 1980s.

4.2 Underestimating institution level risk

Nowhere is the phenomenon of selective learning more easily demonstrated than in the case of the government's attitude to risk management at the level of individual institutions. Risk is inherent to banking. But the Social Democratic Credit Regime allowed the banks to expose themselves to risk to a much lesser degree than what was the case with the liberal regime. As a function of regulatory change and of developments more exogenous to policy, attitudes to risk taking changed within the

banks. But attitudes to managing risk did not, or if they changed they changed towards being more lackadaisical. Neither the banks themselves, nor the central bank or the Ministry of Finance grasped the implications for risk management of a more competitive market in banking. As we shall see, the role of the supervisory body is more open to debate. But more importantly, to the degree that this body did try to warn against the dangers associated with fast credit growth, its warnings were not heeded by its superiors in the Ministry of Finance.

The empirical discussion of the problem of risk management is divided into three main parts. The first part, subsection 4.2.1, lays out the extent of the challenge to precautionary policies that emanated from changed practices within the banking community. Here I will summarise key findings from research on the banking crisis as regards banks' newly found willingness to assume risk and their inability to manage it. The second and third subsections discuss government policies and institutions. Three aspects of precautionary policy will be treated. In subsection 4.2.2 I will discuss both the internal priorities of, and the priority given to, the supervisory body by its superiors in the Ministry of Finance. The relationship between these two bodies is further illuminated by the story of how requests by the banks to build up larger loan loss reserves were thwarted by the Ministry. The next subsection singles out for particular attention the issue of capital adequacy and the decisions that let banks dilute their capital base with subordinate loan capital.

4.2.1 Risk management in a risk seeking culture - changed banking behaviour

Analytically we can distinguish between different kinds of risk that banks (and financial institutions in general) assume.¹²³ Most important for this analysis is credit risk. That is the probability that the borrower will not repay principal and interest as agreed. Total credit risk assumed is a function of several factors. Firstly it depends on the formal demands that banks place on their borrowers regarding financial strength and the gearing ratios accepted. To this one must add the quality of the information

¹²³ The discussion on types of risk draws heavily on Nilsen (1995).

obtained, the bank's general capacity and skill at credit rating and how conservatively the value of collateral is estimated. Secondly total credit risk depends on the composition of the bank's portfolio. It reduces risk if the portfolio is diversified, across customers, regions and industries. The more different regions and industries depart from each other in terms of the business cycle, the smaller total risk will be. Banks can also assume currency risk, interest rate risk, and liquidity risk. All these types of risk arise if the mix between different types of instruments is different on the asset and liability side of the balance sheet. Interest rate risk pertains to the mix between floating and fixed rates (the bank has a problem if it is stuck with expensive fixed price funding when income from floating rates drop). Currency risk pertains to the mix between currencies (the bank is in trouble if has been borrowing abroad and its funding is in currencies that get dearer relative to the currency where it has most of its income. Finally liquidity risk pertains to the dangers of maturity mismatch (the bank is in trouble if a lot of its debts are short term and gets called in while it has long term obligations on the asset side of its balance).

Liberalisation affects the willingness of banks to assume credit risk and their ability to handle this risk through different mechanisms. The most important way that liberalisation affects risk at the level of banks is indirect, through co-causing growth. In the following I will summarise findings on these points from the vast body of research which has been conducted on the banking crisis.¹²⁴ Firstly, credit controls that function creates a queue of customers, it confers power on the bank vis-à-vis their customers. Banks have an incentive to organise their queue of customers according to the credit risk their projects entail. This effect can be compounded by strategies such as extending smaller credits than the customers ask for and/or insisting on shorter amortisation periods (Furnes 1992:89).¹²⁵

¹²⁴ This subsection is in the main based on a report I prepared for two groups of historians writing the histories of Kreditkassen and Den norske Creditbank (respectively, Norway's second largest and largest bank during the 1980's (Tranøy 1997)

¹²⁵ We should also note that interest rate controls further reduce the incentive to engage in risky projects, because such controls more or less remove the banks ability to price its product according to risk. As we have seen credit controls were lifted, circumvented or accepted as banks

Thus when credit controls are lifted or reduced, and banks take the opportunity to grow, they move towards the back of the queue taking on more risky projects. Liberalisation of licensing policy on the establishment of new branches – which tended to operate with ambitious growth targets - had the same effect. A more polemic way of stating this point is to say that under increased competition banks start competing for the least attractive customers. Making do with customers who had trouble getting credit in a less growth-oriented market was something newly established branches were particularly exposed to. Banks could furthermore grow through granting bigger loans to individual loan seekers than what they would have done under a more restrictive regime and they may further be willing to settle for less collateral. Reve (1992:128-138) finds that all these mechanisms for increasing credit risk were active in the Norwegian banking market in the growth period of the mid-eighties.

Fast growth also strains the banks' ability to manage themselves, so to speak, through challenging their administrative competencies. In the mid eighties the Norwegian economy grew fast, with new businesses and new industries appearing while several banks were trying to extend the range of their activities at the same time. Many banks were to an increasing degree exposing themselves to new markets in the sense that the ratio of new customers, new industries, new regions and new financial products relative to established customers and practices increased. Reve (1992:128) makes the point that as soon as banks move outside what have been their core markets one may expect that their ability to assess risk will be reduced. The same goes for their ability to see early warning signals and make appropriate adjustments in time.

With a few exceptions, the major strategic goal in Norwegian banking circles in the early to the mid-eighties was increased growth. A key to implementing this was decentralisation. Front service and the ability to produce rapid responses became cornerstones in the organisational structures established. This meant relying less on hierarchies and groups when making decisions and in stead conferring greater direct

embarked on a strategy of high growth before interest rate controls were removed. This created its own set of dilemmas for regulators which will be analysed in subsection 4.4 below.

responsibility on individuals among the sales personnel. Such a system creates a functional demand for instruments that can compensate for the standardisation, control, and co-ordination that a slower mode of decision making in hierarchies and groups can achieve. At the level of the individual decision-maker it increases the importance of operating with manuals and guidelines. At the system level it creates a need for systems of portfolio management, to avoid that the total risk profile of the bank is not just an “unintelligent” aggregate of individual decisions. Given a growth oriented strategy that actually set volume goals for the sale of credit and rewarded increasing sales there were few other ways of securing a balancing between different risk categories in the banks’ total portfolios. Alas, research on the banking crisis has shown that the major banks were slow in implementing such measures, priority in stead being given to develop marketing and sales (Reve 1992, Meyer 1992, Knutsen 1998, Dokument 17).

A discussion of attitudes to and management of risk in Norwegian banking circles in the boom years should not confine itself to looking at the impact of strategy and organisational structures. This is so because it seems clear that liberalisation also coincided with a cultural shift in Norwegian banking. It has been difficult to find systematic research on banking culture. A broad range of theoretical concerns has motivated the little I have found on the topic. And none of the theoretical contributions referred to below has set out to map banking culture for its own sake.¹²⁶ Still I dare to juxtapose a concept of traditional banking culture with a concept of “modern banking culture”. My justification is, firstly, that although descriptions of new cultural practices in the Norwegian banking crisis literature are scattered and under-theorised, they are still unambiguous on key points.¹²⁷ Secondly there is a strong congruence between different descriptions of the old culture. This holds for my interview material, the

¹²⁶ Swedberg’s (1989) bibliographical effort on the sociology of banks has been of great help when writing about “traditional” banking culture.

¹²⁷ The following argument has benefitted from several discussions and sharing of ideas and data with Birgitte Kjos Fonn. See also Kjos Fonn (1998) which constitutes an exception to the rule of Norwegian banking crisis research to treat banking culture in an unsystematic and under-theorised manner.

Norwegian crisis literature, and the American theoretical literature. Thirdly the picture of two cultures which emerge when holding these literatures together, bring out a clear contrast. The most crucial difference between the two cultures is the implications they have for risk management.

Writing in the USA in the 1950s the organisation theorist Chris Argyris (1958: 506) found that banks wanted individuals with “clusters of characteristics which have functional unity” when recruiting. These were qualities like “meek, quiet, obedient, tactful, cautious, careful and non-aggressive” (Argyris 1954a:72). This contributed to preserving a culture where prudence was a key value. One of Argyris’ (1954a:73) informants put it like this:

You know you have to have a unique temperament to work in a bank. Banks are known for security, stability...

This observation is echoed by Kimbrough (1958). His way of putting it is:

...the general behaviour of bankers must be such that it does not shake the confidence of the public.¹²⁸

The essence of the literature we have looked at so far is that peaceful, conscientious and passive personality types sustain and thrive in a culture which is conducive to instilling trust in the bank’s local environment and its market. We see that a culture that encourages careful and non-aggressive behaviour can be understood as a system for risk management. Careful bank employees do not seek to maximise their lending portfolio. At the same time portfolio management at the level of the organisation loses some of its significance because the majority of projects will be low risk, secured by first mortgage status. These types of commitments will constitute the routine, so it follows that departure from this standard will trigger more reflection, broader consultation and longer processing. It also follows that estimations of collateral value will be conservative, that high gearing ratios will be avoided, and that one seeks to limit one’s exposure to any given customer.

¹²⁸ Halvorsen (1984:409) who did a case study of the fusion between two Norwegian banks around 1980, just before liberalisation, has reached a similar conclusion. His study was not motivated by a desire to understand risk taking and credit decisions, still it is interesting to note that he characterises bank employees in general as *safety-seeking* individuals. And this is a conclusion he draws on the basis of his interview data alone he has no reference to the theoretical American literature.

Another interesting aspect of traditional banking culture is its emphasis on loyalty and stable relationships. In his book from 1957, “Business looks at banks”, Katona asked business leaders when they last changed their main banking connection (Swedberg 1989:169-171).¹²⁹ Stability is defined as relationships that have endured for 12 years or longer. Given this definition almost 70 percent of the businesses had a stable primary banking relationship, while more than 40 percent actually had relationships that had lasted more than 20 years. Katona finds two main arguments for why businesses appreciated stability. One was a norm against “bank-changing”. The term “bank-changer” was understood as derogatory. The second is that it takes time for a bank to get to know its customer, how he operates and what his needs are. These findings can be complemented by interview data from my own research, data that tell us something about why stability was appreciated at the other side of the table too.

When I spoke to leaders representing Norway’s three leading banks after the crisis, they all regretted that the importance of what they called “relationship banking” had been lost during the boom period. One former leader stressed how the cultivation of long term relationships which could benefit both parties over time, had been cast overboard in the search for short term profitability, with insufficient attention accorded to the risks such a strategy entailed.¹³⁰ Another spoke of how he upon entering banking had reacted negatively to all the gossip about customers that circulated among the staff. At first he thought it unethical and distasteful to talk about such personal things as drinking problems and other sources of instability in the private lives of his customers, “it was none of his business”. Later he came to realise that within limits he had to make such information his business. Not for its own sake, but in a proper context. “If you lend someone millions of NOK over 10 years or more, you want to know about things that might affect his ability to repay that loan”.¹³¹ A third informant had several

¹²⁹ I rely on Swedberg’s quite extensive summary of Katona’s work. Katona’s research for the book was based on interviews with a little more than 200 business leaders each representing businesses with a net worth of more than 1 million dollars in 1956.

¹³⁰ Interview with former vice-president in Den Norske Creditbank, Borger A. Lenth 09/06 1992.

¹³¹ Interview with former Bergen Bank CEO, Egil Gade Greve 12/06 1992.

of Norway's biggest building contractors among his customers. Contracting is a highly cyclical business. This CEO spoke of how at several points in his career he was confronted with the choice of cutting credit lines to given contractors thereby choosing a strategy of cutting his losses, or whether to risk even more of the bank's money in an attempt to ride out the storm. The key point here is that his decision was always based on his trust in the leadership of these businesses. Could he trust that they had the business acumen to be able to take advantage of the next upswing, and could he trust that they would want to repay their loans rather than going bust and starting anew?¹³²

The new "modern" culture was in many ways the opposite of the old. Key values were aggressiveness, risk seeking, impatience and "hunger". One way of summing up this change could be to say that the old culture biased employees to focus on the liabilities side of the balance sheet. Banks wanted to portray themselves first and foremost as prudent custodians of depositors' money. Secondly as loyal partners that would stand by and help their borrowers through times of trouble and expect loyalty (and a certain degree of acquiescence) and long term profitability in return. From the early eighties and onwards a culture revolving around the asset side of the balance sheet took over. A culture specific to banking was displaced by metaphors and ideals from other, more "modern" industries. Banking was like any other business. It was about selling your product, as much as possible of it, in direct competition with other financial institutions. Short-term profitability became an imperative. Whom you sold your product to, and how this was funded and by whom was of less importance.

A joke which made the rounds in banking circles after the new, more sales oriented culture taken hold, tells us something about both old values and the contempt they were held in as times changed.

An old school bank employee has been fired and now attends the pump at a gas station. A man drives in and demands - fill her up! - Oh, I should think half a tank would do nicely, the attendant replies.¹³³

In part this cultural shift was desired and nurtured by the new generation of leaders that came into Norwegian banking at the turn of the decade.¹³⁴ One strategy

¹³² Interview with former Kreditkassen CEO Tor Moursund 16/06 1992.

used to bring about cultural change was to change recruitment practices. Experience from sales and customer contact was valued higher than competencies directly related to banking (Kjos Fonn 1998:76). “It is easier to teach a salesperson banking than the other way around” as it was phrased in an internal document in *Kreditkassen* (Knutsen 1998:391). More candidates came fresh from business schools (Dokument 17:57). This was partly because fast growth created a need for new personnel, but it was also done in the hope that business school candidates would bring more aggressive sales-oriented values to the banks. The corollary to this was a de-emphasis on in-house training and the gradual socialisation and the upholding of a specific banking culture that the old recruitment and training patterns helped sustain. In chapter six we shall see that the importance of culture in the context of risk management was not understood by the technocracy. This was the case both for the planning and the implementation stage of liberalisation.

4.2.2 Insufficient precautionary policies - the weakness of the supervisory body

Generally, governments in the advanced industrial nations developed an elaborate set of precautionary policies towards their banking (and the rest of their financial) systems after the calamities of the inter-war crisis. I will define precautionary policies as policies that seek to limit the level of risk assumed by the banks and other measures that aim to strengthen the confidence of depositors. That governments accept an overall responsibility for the stability of their banking systems reflects the risk exposure inherent in banking and the importance of the banking system to the economy at large. Governments have several reasons to protect depositor confidence. The banking system transforms savings into investment and is thus crucial to the economic process in a society, but it also very vulnerable. For one it can be destabilised by real losses stemming from exogenous shocks and/or badly managed

¹³³ I am indebted to Birgitte Kjos Fonn for letting me use this joke.

¹³⁴ All the three big commercial banks got new leadership. Tor Moursund took over as CEO at Kreditkassen in 1977, Leif Terje Løddesøl entered the hot seat of Den Norske Creditbank in 1980, while Egil Gade Greve did the same in Bergen Bank in 1982.

credit risk. But governments also know that liquidity risk may be transformed into insolvency because of unfounded rumours of credit losses. Merton (1949) chose a run on a bank's deposits as his example in his classic article on self-fulfilling prophecies. Furthermore, problems in one bank can easily spread because banks are chained together in mutual commitments and because changes in the level of confidence in one bank can affect confidence in the whole system.

Given that securing a minimal level of financial strength in banks is a primary goal of financial regulation, capital adequacy standards (a ratio of equity to total assets) can be considered "a first line of defence" against increasing losses leading to instability.¹³⁵ Guarantee funds and deposit insurance schemes, provide the second line. Furthermore the central bank must protect the liquidity supply of the system through assuming the role of lender of last resort. This function is an everyday sort of responsibility that forms part of the central bank's capacity to influence interest rates in the economy. In times of crisis and credit crunch, however, it is imperative that someone supplies cash to ease the liquidation of assets and so as to halt the downward spiral of prices (Kindleberger 1984:277).

Depending on the specifics of the institutional set-up of any given country the supervisory body can have several tasks pertaining to issues such as competition and consumer protection. What is of interest here, however, is its key role in precautionary policy. It monitors the banks, securing that rules are followed. Even in cases where the activities are within legal limits it can offer words of warning and advice if risk taking has risen beyond what it deems to be a prudent level. It can also monitor and advise on the banks systems for risk management. Furthermore it advises Government on the making of rules, regulations and policy in general for the financial sector. In Norway it also makes recommendations on concrete issues. For example an application from a bank that wants to increase its quota of subordinated loan capital.

Returning to the case under study here, it is debatable whether the supervisory body did enough, soon enough, to warn against the dangers of increasing losses as the

¹³⁵ Policies relating to capital adequacy will be discussed in some detail in subsection 4.2.3 below.

credit boom got under way. Earlier inquiries into the banking crisis were quite critical of the role played by the supervisory authorities. The accusation was that the supervisory body for too long interpreted the first banks that moved into crisis as individual cases. It did not realise that there were system-level forces at work (SNF 1992:218-266, NOU 1992:30). The latest report on the banking crisis tends to emphasise those warning signals that the supervisory body after all did give. This report also draws attention to what is described as the systemic responsibility of the Central Bank and the Ministry of Finance and government in general. These institutions controlled the instruments that could have made a difference (Dokument 17:78-87). What is beyond doubt and more important to the present analysis, however, is that in general precautionary policies were not adjusted to the functional requirements of a more liberal credit regime. To the contrary, precautionary policies were weakened in several respects as the boom progressed.

The terms and conditions the supervisory body had to work under forms an important part of this picture. The problems associated with the supervisory body can be summed up in three points. Firstly, it had insufficient resources to deal with its new environment. Furthermore, these scarce resources were to a large degree badly prioritised. And when in spite of these limitations it managed to produce warning signals, the reception of these was not very good. Vital inter-institutional communication was hampered by the poor relationship that was between the supervisory body and their taskmasters in the Ministry of Finance. I will review these points in this order.

Until 1986, the supervisory body responsible for banks was *Bankinspeksjonen*. That year this was merged with the body responsible for the insurance companies and real estate brokers. *Kredittilsynet* was created. Considering that we can date key liberalising measures and the beginning of the boom to 1984 this was late. To be in the middle of a merger just as the market peaked proved highly disruptive. In 1985 legislation was passed to create the new body and the MOF refused *Bankinspeksjonen* funding for filling vacancies to which one had found qualified applicants. The argument the Ministry used was that one could wait until the new body was established

(Dokument 17:72). Later on, however, *Kredittilsynet* had great difficulties finding qualified personnel, as the institutions they were supposed to supervise were now recruiting fast, at higher salaries. The inability to recruit at market prices had the consequence that *Kredittilsynet* went through the boom period seriously understaffed compared to its appointments structure SNF 1992: 232, table 6.5.a). There was an irony to this situation. When the crisis had arrived and the banks started shedding labour around the turn of the decade, it was easy for *Kredittilsynet* to recruit qualified personnel.¹³⁶

In retrospect it is also clear that *Kredittilsynet* did not prioritise their resources in a way that reflected the problems building up in the banking sector. This had two main reasons. First of all the new institution spent a lot of energy trying to establish itself as a coherent organisation. Secondly for a long time other tasks than bank supervision seemed more important. Regarding the first point it is pertinent to note that even though legislation creating *Kredittilsynet* was passed in 1985, the new institution was not established until 1986. To compound matters, its first managing director was not installed before 1987. And this man was recruited primarily for his background in organisational restructuring he had no background from the finance industry.¹³⁷ In the interim period the chairman of the board of *Kredittilsynet* acted more or less as managing director (SNF 1992:231). This man, a professor of law, had been instrumental in producing legislation regulating the securities market, and his interests were more in that direction. The stock market had, as we have seen, been liberalised and grown enormously in the preceding years. Consequently, the possibility that working with new problems such as insider trading was considered more interesting and prestigious than on-site bank inspection should not be rule out entirely.¹³⁸ More importantly, however, the MOF also instructed the supervisory body to prioritise work on the securities market in their instructions for 1987 and 1988 (NOU 1992:30:71). The supervisory body's capacity for on-site inspections was further reduced by the fact

¹³⁶ Interview with former *Kredittilsynsdirektør* Svein Aasmundstad 05/03 1998.

¹³⁷ Ibid.

¹³⁸ Interview with officer Erik Lind Iversen, *Kredittilsynet* 04/03 1998.

that several of the most experienced people from *Bankinspeksjonen* were given leadership responsibilities in the new body (NOU 1992:30:71), while other left for the private sector (SNF 1992:235).

With the benefit of hindsight, all the major reports on the banking crisis agree that for a supervisory body the key to perceive, early, that trouble might be brewing in the banking sector, is on-site inspections. It should be noted that this was not just a case of this type of activity being displaced by other activities or weakened by professional mobility. In the latter days of *Bankinspeksjonen*, on-site inspections had been scaled down as part of a deliberate change of strategy. During the long period of small losses on-site inspections gradually came to be considered too costly compared to the results it yielded. In stead a strategy based more on the analysis of data reported by the banks themselves supplemented by on-site inspections took shape. In an age of fast improving computer and telecommunications technology this strategy also seemed more rational.¹³⁹ In 1980 *Bankinspeksjonen* made 57 on-site inspections, in 1985 the corresponding number was down to 8 (NOU 1992:30:76 ft 22). The understanding was, however, that on-site inspections would be increased if indicators in the data made this advisable (NOU 1992:30:72).

As it turned out, however, during the boom period the processing of collected data was more directed towards formal control than actual risk analysis (SNF 1992:245). Also, it took time to rebuild the institution's capacity to conduct on-site inspections after it had been reduced over successive years. The number of on-site inspections conducted continued to decline through 1986 and 1987. It only picked up in 1988, but this was primarily prompted by the stock market crash of 1987, not a perceived increase in credit risk (NOU 1992:30:72).

The third major problem associated with the supervisory body in addition to lack of resources and misplaced priorities, lay in its relationship with the Ministry of Finance. The first managing director served notice in 1992, and he later complained that the officers in the Ministry felt free to intervene in the work of *Kredittilsynet* in a

¹³⁹ Interview with former head of *Bankinspeksjonen* Per Melsom, 04/03 1998.

random and disruptive manner (NOU 1992:30:76 ft 20). The latest report on the banking crisis notes that when the supervisory body at regular intervals presented analyses and reports to the Ministry, these did not normally trigger any particular type of response. The exception was when it made specific recommendations, but here the response on key points was negative (Dokument 17:81). My interviews with former employees at *Kredittilsynet* strengthen the impression that the Ministry could have held the supervisory body in higher regard than it did. Two concrete and important issues can serve to illustrate this point.

First, as early as in 1983, *Bankinspeksjonen* did produce an analysis that emphasised the positive relationship between increased competition increased credit risk and banking crises. Based on OECD findings from 1980, it underlined that unfettered competition might not be an appropriate mode of regulation for the banking sector.

...increased competition produces increased risk exposure in banking. This effect will be visible only in the period after the initial phase of increased competition. The background is that increased risk is not accommodated through increasing loan-loss reserves. This would have demanded better profit margins, in stead margins have tended to fall.¹⁴⁰

In hindsight we can see that this analysis was spot-on. But, it was not taken into consideration as work on liberalisation progressed. To the contrary, *Banktilsynet* felt more or less ridiculed for having made these points (Dokument 17:86). Maybe this had to do with the vague but still quite “unfashionable” policy recommendations the supervisory body drew from their analysis:

...One cannot disregard the possibility that there will be a need to sanction agreements within the industry and in addition it may be necessary for the authorities to intervene against competition that threatens the stability of the banking sector.¹⁴¹

Trying to strengthen cartel-like business practices in the Norwegian banking sector was a non-starter with the Ministry of Finance. However an analysis linking competition and risk could yield two other concrete and potentially less controversial implications for how policy should have been formulated within the domain of precautionary policy. Namely in the issues of loan-loss reserves and subordinate loan

¹⁴⁰ The excerpt is taken from a written submission to the Ministry of Consumer Affairs and Government Administration (Quoted from Dokument 17:86). Translation mine.

capital. As we shall see, the supervisory body took a line consistent with its own analysis on the matter of loan-loss reserves. At the same time it took a surprisingly liberal stance on the issue of capital adequacy, that is the limits for subordinated loan capital to be precise.

The rules concerning loan loss reserves stemmed from 1951 and said that yearly provisions could not exceed 1 percent of total loans. If a bank suffered losses of 0.2 percent of total loans one year, this meant that the fund could grow at most with a 0.8 of total loans. This was unless realised losses surpassed 1 percent. In such cases provisions could be increased correspondingly so that the fund was not reduced in nominal terms (NOU 1992:30:19). Accumulated provisions could maximum correspond to 5 percent of all receivables. During the period of high growth lending this system tended to produce a decreasing ratio of reserves to total loans and the bankers association and the supervisory body voiced worries over this. At three different times during the boom and even after the first signs of crisis were visible (in 1986, 1987 and 1989 respectively) the supervisory body suggested that banks be allowed to increase their provisions. On all three occasions the Ministry of Finance turned down these requests.

4.2.3 Insufficient precautionary policies - dilution of capital standards

Capital adequacy requirements (a ratio of equity to total assets) is meant to secure that banks have a buffer of own funds that can be posted against losses before the funds of depositors and other lenders to the bank come into play. We can distinguish three main types of equity. Share(holders) capital, retained profits (typically in the form of loan loss reserves), and subordinated loan capital. Share capital and retained profits constitute “true equity”. Subordinated loan capital enjoys a legal status between “true equity” and ordinary loan capital. In case the bank should fail it is subordinate to what other money the bank has borrowed (that is deposits from customers and other banks), but it is privileged compared to share capital. Also, it cannot be written off against losses while the bank remains in operation. Standard

¹⁴¹ Ibid.

subordinated loan contracts demand that a bank be brought to liquidation before subordinated loan capital can be lost. That is the theory. It is also the legal logic behind letting subordinated loan capital count as part of a bank's capital base under the rules regulating capital adequacy.

From the early 1960s and towards the end of the 1980s the story of Norwegian capital adequacy regulation is one of increasingly lax rules. In legislation produced in 1924 – under the shadow of the post world war one crisis - capital adequacy requirements were set at 10 percent. This remained the formal requirement until 1961 when it was reduced to 8 percent.¹⁴² Neither the 8 nor the 10 percent requirement was ever fully lived up to (Dammann 1991:92, Petersen 1982:239). This motivated a revision of legislation and in 1972 the requirement was reduced again, this time to 6.5 percent. At the same time a moderate type of risk weighting was introduced. “Secure” assets such as deposits with the Postal girobank, the Central Bank and government bonds were taken out of the basis of calculation. In sum these revisions amounted to a real reduction in the requirement of 25 percent. This means that with an unchanged capital base a bank could now “carry” a balance that was 33 percent higher than they could legally do under the old rules (NOU 1992:30:87).¹⁴³

Throughout this period of gradual change to the capital adequacy regime there was an opening for letting part of the requirement be filled up by subordinated loan capital. No limit was specified, but the law said that the authorities could grant permission for this, upon request. Until the late 1970s this was of no real consequence. The banks themselves were wary of this instrument because it was not compatible with what I have called traditional banking culture. The leader of Norway's biggest bank through 25 years and arguably the greatest banker of his generation, Johan Melander of DnC, was quite blunt – “subordinated loan capital is a debt, nothing else”

¹⁴² At the same time both equity and assets were redefined in ways that served to make the rules more liberal than before. On the other hand precautionary policies were also strengthened since membership in the commercial banks' insurance fund was made mandatory (NOU 1992:30:21).

¹⁴³ The 1972-revisjonen cannot, however, be interpreted as an unambiguous weakening of the requirements. Because now it was nailed down that the requirement should be met at all times by all commercial banks. In addition to this the yearly fee to the insurance fund was raised from 0.1 percent per year to 0.15 of the banks' total assets.

(Dammann:1991:95). To him it represented a dilution of equity and was thus a dubious instrument for a reputable bank (Lie 1998:29).

Melander retired in 1980 and by the late 70's attitudes to subordinated loan capital were visibly changing. As we have seen, a new generation of leaders was taking over in all three major commercial banks and strategies were becoming more and more growth oriented. There were limits to how much equity that could be built up through issues and retained profits. If banks wanted to grow they needed to increase their capital base somehow. Internationally a market for subordinated loan capital was emerging. Another feature of this type of financing compared to issuing new stock was that it reduced the numbers of shares in circulation. In at least one major bank this was seen as an advantage based on the argument that fewer shares meant higher share prices (Knutsen et. al 1998:302). The attractiveness of subordinated loan capital was also increased by the fact that it is normally cheaper to serve than share capital (NOU 1992:30:21).

Initially the commercial bank's applications for increased use of subordinate loan capital were viewed in a positive light by the authorities involved. It was part of an international trend, and in Norway there was also an idiosyncratic factor at work, namely a consequence of the 1970's debate on "bank democratisation". The threat of some kind of public take-over of the banking system did for several years make it difficult for the commercial banks to court private investors (NOU 1992:30:23). By 1981 subordinate loan capital had grown from a negligible level of less than one percent of "true equity" to a level that corresponded to 38 percent. This had the Ministry worried. Even though the ratio fell by some 10 percentage points over the next two years, it sent out a letter in January 1984 recommending that the banks rely more on share issues and less on subordinate loan capital. Still, they opened up for new loans. But this was to be accepted only after due considerations of each case, and only up to a level corresponding to 50 percent of true equity. At the same time the Ministry asked *Bankinspeksjonen* to consider whether 40 percent might be a more appropriate limit (Dokument 17:127). This indicates that the Ministry was in two minds about its policy on this issue. Most likely there was a conflict between parts of the technocracy

and the Minister himself, Rolf Presthus from the Conservative party, who wanted the 50 percent limit.

Bankinspeksjonen replied to the Ministry supporting the 50 percent rule and consequently a practice was embarked upon where all commercial banks that wanted to were granted the right to fill up their adequacy requirement to this limit. The banks were quick to avail themselves of this rule. By 1986 the commercial banks as a group had subordinated loan capital that corresponded to 43 percent of their real equity. In 1987 the 50 percent limit was surpassed. The aggregate numbers for 1987 and 1988 were 55 and 85 respectively.¹⁴⁴

That the limit could be surpassed so fast reflected that the three major commercial banks during 1986 had started to use an instrument new to the Norwegian context, so called *perpetual subordinated loan capital* (“evigvarende ansvarlig lånekapital”). They requested permission to let this type of capital to come in addition to “regular” subordinated loan capital, that is subordinated loan capital with a maturity date. Their suggestion for a new formula was 50+50. This meant that the banks now wanted permission to let the total sum of perpetual and “regular” subordinated loan capital correspond to 100 percent of their true equity. *Kredittilsynet*, recommended that the 50+50 formula be accepted, but that some conditions should be attached concerning details on repayment. When it turned out that all the contracts already entered into by the big banks did not satisfy all their conditions the supervisory body recommended that these loans should be approved anyway. The Central Bank supported this stance. In November 1987 the Ministry of Finance granted permission for this, and the banks could now legally let their perpetual loans count as a part of their capital requirement (Dokument 17:127).

This decision reflected that the banks involved and their business association had waged a successful lobbying campaign for diluting capital standards further. Their main argument was that if permission was not forthcoming this would force them to

¹⁴⁴ This number was calculated by the author on the basis of table 1.3.1 in NOU 1992:30:22. This table gives the sums for the commercial banks taken together, so it cannot be used to calculate ratios for individual banks. For numbers on the three biggest banks see Dokument 17:127-128).

increase retail interest rates even further. As we saw in chapter three, this was at time when interest rate controls had been given up formally, but where politicians from all parties were still working hard to keep retail interest rates as low as possible. A second argument used was that – seen isolated – the 50+50 formula was already in use in countries such as Great Britain and Sweden. The formula was also taken up by a committee working under the auspices of the Bank of International Settlements (BIS). This committee was trying to develop a common international capital standard, which in turn formed the basis for the standards the EC agreed on the following year. The BIS-committee did not deliver its final recommendations before the summer of 1988, but work had been under way for several years, and the 50+50 formula had appeared in preliminary documents.¹⁴⁵

Upon closer inspection though, we see that the regime the largest commercial banks proposed and got implemented in 1987 was much more lax than what eventually came out of the European process. Four differences need to be highlighted.¹⁴⁶ 1) The International capital ratio standard eventually became 8 percent not 6.5 as the Norwegian system still operated with at this time. 2) The EU directive took the concept of fine-meshed risk weighting fully onboard.¹⁴⁷ With the asset portfolios the leading Norwegian commercial banks had at this time, an application of this principle would have made the requirements tougher to meet.¹⁴⁸ 3) The EU-directive included all *off-balance sheet commitments* in capital adequacy determinations. This would also have made it tougher for the Norwegian banks in question here. 4) The EC standard demanded that perpetual subordinated loan capital could be written off against losses, before banks went into liquidation.

¹⁴⁵ Interview with former department head of division, Ministry of Finance, Mads T. Andenæs, 21.07.1998.

¹⁴⁶ My presentation of the EC directive is primarily based on Nilsen (1995).

¹⁴⁷ The old Norwegian system had one element of risk weighing: State and state guaranteed bonds did not count as part of basis for calculation.

¹⁴⁸ Some examples of how the system works are: State and state guaranteed bonds within the OECD area, has a weight of zero. Claims on or guaranteed by financial institutions within the same geographical area has a weight of 0.2, while claims on households and business without collateral in real estate has a weight of 1.0.

By 1987 then, Norway's capital adequacy regime was very weak. The 6.5 requirement was a low one, risk weighting was poor, and off-balance sheet commitments were not integrated. All this made the high tolerance for subordinate loan capital more problematic. Above we saw that in most of the contracts Norwegian banks had entered into the bank had to be brought to liquidation before subordinated loan capital could be lost. As it turned out Norwegian authorities preferred to bail out all, except one, of the banks that got into trouble. This practice is, in it-self an argument against considering the type of subordinated loan capital Norwegian banks had taken on as equity. But even the presence of an EC-style clause allowing banks easier access to writing off subordinated loan capital would not have been of much help. The barriers to letting the investors suffer were too great.

Foreign institutional investors had provided almost all the subordinated capital. Share holders can expect to see their dividends dipping and the value of their shares fall – it may even be lost – in times of crisis. The creditors behind the subordinated loans did not even lose any interest due, much less their principal. This is primarily because it was perceived that such a move could discredit the whole Norwegian banking system. It would most probably mean that Norwegian financial institutions would be downgraded by the international credit rating agencies. Through this mechanism a cost to international investors could translate into increased funding costs for the entire Norwegian banking system.

The upshot of this, of course, is that as a buffer against credit losses, subordinated loan capital proved to be purely fictitious. Melander was proved right. Subordinated loan capital did not provide the defence against hard times that it promised and which provided its justification in the first place. But there is also a second reason why subordinated loan capital is interesting to the study of a policy assisted boom and bust sequence. This reason relates to crisis prevention. That is, the build up to the crises, more than defence against the impact of losses. Without permission to fill up increasingly more of their capital adequacy requirements with subordinated loan capital, it would have been as good as impossible for the Norwegian commercial banks to fund their phenomenal growth rate and keep in line with these

requirements at the same time (NOU 1992:30:87). Profits were not even high enough for the banks to build up equity capital at the pace they grew with in the years of moderate growth (Petersen 1982:220). For this to occur in the years of hyper-growth then – even when supplemented by regular share issues – seems highly unlikely. The same problem of low profit margins applied to seeking new investors through share capital as well. Norwegian banks issued new shares at a relatively high pace during the early and middle eighties. It would have been very difficult for the banks to provide a satisfactory yield on such funds if they had been forced to issue substantially more than they already did (NOU 1992:30:87).

Thus we can conclude that the liberal stance taken on the issue of subordinated loan capital exacerbated problems at two stages of the boom and bust cycle. First it represented a missed opportunity to check the hyper-growth of the boom period. At the same time this policy allowed a weakening of the banking sector's defences. This came back to haunt the banks when major losses set in the bust period. In section 4.5 I will try to make sense of these – in hindsight clearly misguided – decisions in a selective learning perspective. First, however, in the next two sections, the technocracy's failed attempts at gauging and controlling the boom will be described.

4.3 Underestimating the strength of the upswing - inadequate statistics and theory driven interpretation

Both the Ministry of Finance and the Central Bank long underestimated the magnitude of the credit explosion that got under way during 1984. This was due both to weaknesses in the statistics gathered during the boom, and to the interpretation to which the available statistics were subject. The trouble these milieus had interpreting what was going on was related to their conviction that credit controls could not work efficiently. Credit “is like water - it finds its own way”, was the metaphor circulating in reform eager circles in the run-in to liberalisation.¹⁴⁹ In this case “finding its way”

¹⁴⁹ Sverre Walter Rostoft, interview 26.05.92.

referred to grey markets. In chapter two we saw that grey markets attracted a lot of intellectual energy in the central bank in the run-in to liberalisation. The inference drawn was that credit controls invariably stimulate such business. Ultimately this renders inflation management impossible. Thus went the single most important argument for liberalisation in Central Bank circles (Tranøy 1993:163-166).

Having argued like this both the central bank and the ministry was inclined to interpret the credit expansion that followed liberalisation as largely, if not fully, illusory. Expansion was not real, it was a case of "Old funds" returning from the grey markets to the "legitimate" balances of banks and other institutions. In a letter dated 3. August 1984 *Norges Bank* - on the basis of this interpretation - warned against reacting to increased bank lending by increasing interest rate levels or primary reserve requirements.¹⁵⁰ Figures collected later indicate that such a book-keeping phenomenon does indeed account for part of the expansion (NOU 1989:60, table 4.1). However, the same figures demonstrate that there was also an impressive net growth in credit supply. But as the central bank's letter shows, the focus on grey markets arguably weakened the case for ringing alarm bells to the politicians ultimately responsible. In *Norges Bank's* response to one of reports on the banking crisis that came out in 1992 (NOU 1992:30) the institution admits this explicitly (St.Meld.39 (1993-94):59):

In retrospect one can see that the growth in lending during 1984 and 1985 should have been interpreted differently...One should have placed more emphasis on how credit market statistics indicated a significant growth in credit, and less emphasis on the fact that the numbers also reflected that the banks were bringing back loans that had previously resided in the grey market...¹⁵¹

The commission on the banking crisis instigated by Parliament goes further than claiming that the vision of the technocrats was clouded by poor data and a theory-driven interpretation. It also raises the question whether there was an element of *wishful thinking* when credit market developments were analysed and planned for in 1984, 1985 and 1986 (Dokument 17:48-49). The committee raises this question after looking at the discrepancy between various targets published in different budgetary

¹⁵⁰ St. Meld.39, 1993/94, here quoted from Dokument 17:47.

¹⁵¹ My translation.

documents and the actual supply of credit from the banks as measured later. Credit supply for the year of 1986 provides the most dramatic example of a trend clearly present in the whole 1984-87 period. In the national budget for 1986 (produced in the autumn of 1985) bank lending was targeted with an increase of 23 bn kr. In next year's national budget - that is 8 months into the year in question - the target was reduced to 19 bn. NOK. The actual growth in bank lending as measured in 1988 turned out to be nearly 51 bn NOK., that is a discrepancy of nearly 32 bn. NOK. or 168 percent!

Part of this discrepancy can be accounted for by a practice of fraudulent bookkeeping that some banks resorted to in these years. Even so, the report concludes that the size of this blunder is not solely explainable with reference to the quality of the information available in August 1986 when the revised target of NOK 19 billion was formulated.¹⁵² Even the numbers available at the time indicated a much stronger growth in bank lending than what one would expect reading only the budgetary documents. According to bank-statistics available at the end of August 1986, bank lending had already grown by 17 bn. This corresponded to an average monthly growth rate of 2.2 bn. NOK. Still, the budgetary document assumed that in the *remaining 4 months* of that year the total growth would be 2 bn kroner. That is, one assumed that market growth for four months would total less than what the market had grown by on average in each of the preceding 8 months.

In September 1985 the same phenomenon had played itself out. At that juncture the available bank statistics revealed a monthly growth rate of 4.4 bn. kr. for the months from January through August 1985, while the budget assumed a total growth of 4 bn. kr. for the rest of that year. Again the total for 4 months was assumed to be less than the previous monthly average. Hence, in both 1985 and 1986 a sharp fall in the growth rate was assumed to take place in the autumn. As the Commission remarks, this was assumed in the absence of the kind of draconian measures which could have made this unlikely development more probable (Dokument 17:49). To this it should be added

¹⁵² Holter, Stray og Nilsen 1987:74-78 give an early analysis of these fraudulent practices. One practice that was clearly in breach of not only the spirit but also the letter of the law was when some banks registered lending to the public as deposits in other banks to avoid the impact of primary and supplementary reserve requirements.

that the autumn of 1985 saw another increase in primary reserve requirements, but this was a weak measure at the best of times. And as we shall see below, in the autumn of 1985 it might even have been counterproductive. October 1985 also saw the abolishment of interest rate controls. If this had been a sincere policy it could have helped curb credit growth slightly. But again, and as we saw in chapter three, the downwards manipulation of money market rates which accompanied this measure also took the sting out of it. Furthermore it is interesting to note that in the autumn of 1986 the blunder for 1985 was already clear from the revised numbers for that year. Still, the mistake was repeated for 1986. On top of this we might add that a sudden decrease in the growth rate seems all the less probable in light of the self-reinforcing mechanisms at work in periods of accumulated credit growth and asset price inflation.

Another observation that could have lead leading decision-makers towards a deeper appreciation of how unbalanced the Norwegian economy was in the mid-80s, was the boom in private consumption that accompanied rapid growth in bank-credit. If we compare statistics made available at different points in time, we see that information on private consumption reached the technocracy late. Still, the available figures were dramatic enough to have warranted more of a reaction. Again, however, the theory informing decision making served to obscure the importance of what one in hindsight can see was an important development trend. I will discuss the reporting of data first, then move on to their interpretation.

Final figures for the rate of growth in private consumption show a staggering 9.9 percent in 1985 and 5.6 the year after. This clearly constituted a consumption boom, but it must have come as a surprise. In the fall of 1984 the national budget estimated this indicator to reach 2.4 percent in 1985. Next autumn the estimate had been increased to 6 percent, a dramatic increase but still some way off the 9.9 percent that was the final figure. A corresponding dramatic fall in the savings rate of households (from 5.2% in 1984 to minus 2,6% in 1985) was picked up even later. As late as in september 1986, the estimate for 1985 was still positive (Steigum 1992a:42) The savings rate continued to fall sharply, bottoming out at around minus 5 percent in 1986 and 1987. Then it recovered fast during the late 1980's, getting positive again in

1988 and peaking at almost 7 percent in 1993.¹⁵³ As we shall see in the next chapter, towards the end of 1986 and in 1987 policies were tightened dramatically providing an incentive for people in debt to start saving again. The exchange rate was fixed, and nominal interest rates rose in order to defend it. Partial tax reform was achieved bringing real interest rates further upwards while fiscal policy was also tightened.

I will not here delve further into how economic policy helped set the stage for the bust phase, that is the topic of the next chapter. But in order to broaden the present discussion of selective learning I need to anticipate the following chapter on this one point: The Ministry of Finance and other planners were as unprepared for the fast recovery of the savings rate as they had been to its initial fall. This made it more difficult to formulate more appropriate (i.e. less pro-cyclical) policy responses during both the upturn and the downturn. Several economists writing on this period have concluded that the monitoring of, and predictions regarding, the business cycle of the Ministry of Finance, the Central Bureau of Statistics and the central bank left a lot to be desired. (Steigum 1992a, Reinertsen 1992, Hanisch 1996). In essence both swings in consumer behaviour (and in turn in the economic climate) were underestimated. During the upturn the significance of dramatic increases in consumption and borrowing was, as we have seen, not appreciated. In the downturn the main problem was that the degree to which a highly indebted economy would cool off by itself was underestimated. These oversights reflect a blind spot in the “Oslo school”-tradition that still informed macro economic modelling in Norway. The problem was that at this time (until the early 1990’s) there was no place for changed credit market behaviour in Norwegian macro economic planning. Indebtedness was not a variable in the models used by the Ministry of Finance at this time.

In the words of the commission led by professor of economics Preben Munthe, (NOU 1992:30:96).¹⁵⁴

It is doubtful whether the models employed by the authorities has a good enough foundation in the behaviour of Norwegian economic actors. Matters pertaining to wealth and indebtedness were ignored in the models and are hardly present in Norwegian macro-economic thinking in

¹⁵³ Isaachsen and Larsen (1998:107).

¹⁵⁴ Translation mine.

general. Therefore insufficient attention was given to the dramatically increasing discrepancy between the indebtedness and the incomes of consumers. The same was the case as regards businesses. In hindsight it is, however, easy to see that a period of rapidly increasing indebtedness must be followed by a levelling out or a turn. The boom contained the seeds of recession.

4.4 Underestimating the willingness to grow - paradoxical effects and attempts at controlling the boom

Even if the strength of the expansion was consistently underestimated, there was still some awareness in the Ministry and the Central Bank that bank lending was expanding too rapidly. The main tool utilised after supplementary reserve requirements were lifted in 1984, was primary reserve requirements. Primary reserve requirements was in effect a proportional tax that forced banks to keep a fraction of their balance in cash, low yielding government papers and as low income deposits with the central bank. This requirement was raised several times during 1984 and 1985. That is, an increasingly bigger fraction of bank's balances were demanded kept in low-yielding assets (NOU 1989:1:139). When the authorities reached the limits set by the law in the autumn of 1985, the Willoch government changed the law.¹⁵⁵ The requirements were raised again in the spring of 1986.

The logic motivating the Ministry was the following. First, they assumed the banks had close to a flat curve for marginal income. This was based on the observation that formal and informal interest rate regulation made it difficult to achieve much through this aspect of pricing policy. Second they assumed that banks had increasing marginal costs. Since lending up to a certain point could be funded by deposits before funding at money market rates "took over" this also seemed reasonable. The introduction of increased primary reserve requirement then, was meant to shift the marginal cost curve upwards, so that it would intersect with the marginal income curve "earlier" that is at a lower volume than what would otherwise have been the case. This is textbook microeconomics. And there is little doubt that primary reserve requirements did - other things equal - contribute to increased marginal costs and thus reduced

¹⁵⁵ .Ot.prop.nr. 17.1985.

profitability. Furthermore this made the banks even less able to deal with losses when these arrived later.

There is, however, scant evidence that the banks responded the way they were “supposed to”. As they were competing fiercely for market shares they were apparently insensitive to the profit-reducing effects of primary reserve requirements. In fact it can even be argued that increasing this tax had a perverse effect on the banks as they tried to compensate for it by means which seemingly stimulated the growth dynamic. The banks were behaving in a manner that was impossible to predict and very difficult to make sense of viewed through the analytical lenses of the macro-economists of the Ministry of Finance - and *Norges Bank* for that matter – but we shall return to the Central Bank’s view below.

The “logic” driving the banks was the following: Up until and after nominal interest rates were formally freed, many banks tried to compensate for the costs induced by the reserve requirements by increasing their non-interest charges.¹⁵⁶ As we have seen above, raising interest rates was not really a realistic alternative. In turn this stimulated lending “artificially”, creating strong incentives for fast paced credit growth. This was because the full income from non-interest charges were credited the year the loan was made instead of being distributed over the life-span of the loan in question, as would have been case with income from regular interest payment. Another way of putting this is that non-interest charges contributed to increasing profitability in the short run, while the fast growth that accompanied it increased non-compensated future risk exposure.¹⁵⁷

That banks in general showed a lack of sensitivity to the costs imposed by increased primary reserve requirements is part of a larger picture. A characteristic of

¹⁵⁶ Trond Reinertsen, Einar Forsbak, Egil Gade Greve og Tor Moursund interviews 27/5, 11/6, 12/6 and 16/6 1992.6 1992. See also Johnsen (1992:83) and Lie (1998:96-98).

¹⁵⁷ This illustrates that it can be dangerous to apply formal rules to informal practices. In a nominalist perspective on accounting the banks in question did the obvious thing: Non interest charges is not the same as income from interest paid, so it shall be treated as an income accrued that year. In reality however, a large proportion of this income was taken instead of income from interest. According to traditional principles of banking, income from interest partly reflects the risk involved over the life time of a loan, so it is accrued accordingly.

the boom period is that Norwegian banks displayed an unprecedented willingness to grow with reduced margins in their core activity as intermediaries. For a while some of the biggest banks partly made up for this through increased incomes from currency and stock trading. But operating profits still fell for the banks as a group through the growth period (Johnsen 1992:74-76). In itself this was not a sound business reason to expand lending anyway. To sustain fast paced lending growth the banks had to bring in more and more funding at money market rates. Until the end of 1986, however, money market rates were sometime above and sometime just below the rates charged from customers (Johnsen 1992:82, figure 3.5). Different measures of the margins made in core activities all paint the same picture. Funding became more expensive relative to income from lending. This can also be read off from lending/deposits ratios. This indicator rises from 0.79 in 1980 to 1.11 in 1985, before it jumps to 1.50 in 1986.

Research on Norway's two biggest banks reveal that top management did not manage to get fully on top of the growth process. They communicated in an inconsistent manner. Sometimes the call was to show moderation, at other times not. Even if this inconsistency makes it more difficult to operate a measuring rod it probably still makes sense to say that they grew faster than top-management had planned for, and wanted (Lie 1998: 128 , Meyer 1992:198). Given that lack of control over, and limited comprehension of, what was going on also to a certain degree extends to top management inside the banks, one could hardly expect the Ministry of Finance to have had a full and deep appreciation of what was going on either.

Still, when it came to primary reserve requirements there were warning voices. *Norges Bank* did not like this instrument. The Central Bank had found them to be slow working and since they stimulated grey market activity, primary reserve requirements could also be said to complicate attempts at managing the credit market. Without permission to hike interest rates, however, *Norges Bank* was not able to come up with an alternative. Consequently it did not recommend reducing them (Dokument 17: 37, Hanisch et.al 1999: 295). Norwegian Bankers Association (NBA) was clearer in its opposition at this point. Its leadership understood the interplay between primary reserve requirements and non-interest charges. The NBA repeatedly tried to point out

that this regulation did not have the desired effect, but the Ministry of Finance disagreed with the NBA's analysis.

In an unprecedented move the NBA then proposed that the MOF should replace primary reserve requirements with a measure that would have a more direct effect on the marginal cost curve of banks. The suggestion was that the MOF should replace primary reserve requirements and reintroduce the - in banking circles dreaded - supplementary reserve requirements. This measure taxed growth per se. It was not like primary reserves, calculated in a proportional manner as a fraction of the balance of the banks. To emphasise that what one wanted to achieve was to increase the marginal costs associated with growth, the NBA suggested that supplementary reserves should be designed with tranches this time.¹⁵⁸ Given what we now know of how far the banks were willing to go in order to circumvent such regulation and their general willingness to grow with shrinking margins, one can question how effective this measure would have been. Still, the eventual outcome, effective as of January 1986 came close to representing the worst of both worlds for the NBA. The MOF continued to employ ever-higher primary reserve requirements. At the same time supplementary requirements were reintroduced, albeit in a more moderate form than that which had been practised in 1983, before liberalisation. The story of the reintroduction of supplementary reserve requirements in 1986 also illustrates that relations between the Ministry of Finance and the NBA were strained. Conceivably a better dialogue between these two parties could have facilitated a better understanding in the Ministry of what was actually going in the banking sector.

¹⁵⁸ Interview with Trond Reinertsen, 27.05 1992.

Chapter 5: The bust years – Too much too late

This chapter is about the politics of bust-inducing policies. In the two preceding chapters the task has been to describe and explain how and why the economic expansion was stimulated by policy for so long. In this chapter the task is to describe and explain how and why the policy of contraction (finally) came when it did, why it was overdone in terms of both dosage and duration, and to describe the economic trajectory that these policies co-caused. The main period covered is from 1986 when the price of oil collapsed and the impetus to take a more austere stance was broadly recognised, through to December 1992 when relief from austerity arrived in the form of a forced exit from the self-imposed exchange rate constraint. The chapter also includes an epilogue, discussing whether Norway has managed to establish new, stable routines towards the end of the 1990s.

In hindsight it seems inevitable that OPEC's low cost "swing producer" Saudi Arabia at some point should want to defend her market share. In the 1982-85 period this was threatened both by quota cheating cartel members and the aggressive marketing of non-OPEC, primarily high cost producers like the UK and Norway (Claes 2000: chapter 5). When it occurred in early 1986, however, the oil price fall clearly qualified as an external shock.¹⁵⁹ As we shall see, during 1986 and 1987 policy makers across the political spectrum gradually came to the conclusion that Norway had allowed itself to become too dependent on oil revenues. The standard analysis became that the increasing stream of cash from the North Sea had in effect been a cushion for Norway to hide behind, enabling its decision makers to delay painful decisions. This was no longer to be the case. From late 1986 and onwards the Norwegian political

¹⁵⁹ It can be argued that Norway was warned. While OPEC to a large degree tried to keep internal conflicts to themselves, the organisation's unhappiness with the "free-riding" strategy of producers like Norway and the UK was out in the open. In the summer of 1985 I was part of a group of Norwegian political science undergraduates that visited OPEC headquarters in Vienna. The presentation focused on long term trends in the oil market. These clearly showed how OPEC had been sacrificing a bigger and bigger market share in order to defend the price of oil. Towards the end of this presentation the official giving the talk actually told us to go home and ask our government which party would be the loser if a price war broke out!

system managed to cut through the stickiness hitherto associated with issue areas such as the exchange-rate/interest rate policy nexus, tax reform and fiscal policy, at the same time preparations for adapting to the SEM were being made.

The title of this chapter “Too much too late”, refers to the character of the “turning operation” set in motion by the incoming Labour government of May 1986.¹⁶⁰ Few contemporary – or later - observers would argue that a tightening of policy was uncalled for. The incoming administration faced a booming economy driven first and foremost by over-expansionary financial institutions, asset price inflation and a consumption boom. Imports were buoyant, and when the oil price nose-dived, the external balance deteriorated dramatically. The loss of a huge part of the cash flow from the oil sector demonstrated to all and sundry what the technocracy already knew, namely that “mainland” Norway (and the “off-shore” sector for that matter) had a cost competitiveness problem. The current account went from big black figures to just as big red numbers in the course of one year. In 1985 the positive balance corresponded to slightly less than 6 percent of GDP, in 1986 the same indicator showed a negative balance of more than 6 percent (Steigum 1992a:50). The petroleum sector’s contribution to GDP (the value of oil, gas and pipeline transport) fell from 19.1 percent in the peak year of 1984 to 8.6 percent in the bottom year, 1988. Tax revenues from the sector peaked at 77.4 billion NOK in 1985 and fell through to 15.7 billion in 1988.¹⁶¹ In short, Norway’s economy was in dire straits, with no immediate prospects for improvement, at a time when Europe presented Norwegian policy makers with the greatest challenge from that source ever, in the shape of plans for the SEM.

In my review of the Social Democratic Credit Regime in chapter two, I drew attention to the fact that this regime had counter-cyclical routines built into it. Mjøset’s

¹⁶⁰ The term “turning operation” is a direct translation of the Norwegian term “snuoperasjon”. To my knowledge, business consultants, referring to what should be undertaken by loss making business entities, were the first users of this term. The Minister of Finance in Labour’s government from May 1986, Gunnar Berge, however, used it repeatedly throughout his tenure. His tenure lasted until after the elections of September 1989.

¹⁶¹ All numbers in this paragraph, unless otherwise is stated, were kindly given to me by Dag Harald Claes, Norway’s leading academic authority on the political economy of oil. The figures for tax revenue are inflated to achieve comparability (they all correspond to the 1999 value of the NOK).

(1986, 1987) work on post-war Nordic macroeconomic policies also marks the “Norwegian model” as clearly counter-cyclical. This means that when over-heating threatens, tighter policies were to be expected as a matter of routine following. During Willoch’s time in power policy had, however, tended towards being increasingly pro-cyclical. It was moderately tight during the mini-recession of 1981-83 and got looser and looser as the boom picked up pace during 1984 and 1985. Now Labour was back in power, but what started in 1986 was no routine contraction. It was much more than a case of changing the setting of discretionary policy instruments. Discretion was used in incomes and fiscal policy, but this was to be combined with structural reform of the tax system and following through with liberalisation of the markets for credit and currencies, while at the same time developing a new long term strategy for exchange rate management. The task of co-ordinating structural reform across several issue areas with stabilisation policy was very difficult. About as complicated as overseeing an expansion stemming from the interaction of several newly liberalised markets had already proved to be.

As notified in chapter 2 (subsection 2.3.3) I seek to draw causal links between the timing, content and rigidity of the turning operation and imported dynamics. This is a choice of analytical focus and narrative structure, motivated by my reading of the history of the period. Two potential misconceptions must be warned against, however. The first is that this does not mean that domestic level processes are discounted. Hopefully this should be clear from the theoretical discussion in subsection 2.2.3. Still, I will stress that my concept of imported dynamics entails a conceptualisation of the relationship between external and domestic level factors that differs from the type of one-sided outside-in analysis that to some degree can be associated with studies coming out of International Relations and International Political Economy.¹⁶² Rather, I

¹⁶² For an explicit attempt at one-sided outside-in modelling coming out of IPE see Andrews (1994). Andrews, in turn, holds up Waltz’ agenda setting structural realist theory of International Relations from 1979 as his ideal. Goodman and Pauly (1993) and Moses (1994) are other examples of a kind of analysis that (in my opinion) places (too) great emphasis on the importance of the international environment when seeking to explain domestic choices. Again in my interpretation, these works typified a trend in the early 1990s that on the empirical side was heavily influenced by observing the trend towards monetary and regulatory convergence in Europe at the time. When

see this relationship as one where external factors emerging in the form of pressures, initiatives and solutions are mediated and sometimes actively sought out by national level institutional actors.

The second possible misconception is that I should wish to imply that imported dynamics were not important to the developments sought explained here before 1986. This is not the case. In chapter three for example, we saw that the great inflow of foreign short term capital that came to Norwegian banks during 1984 and 1985, contributed to funding the boom. Or we could have taken a macro perspective and said that without a successful OPEC in this period, oil revenues would not have been large enough for the economic climate to get as overheated as it did in the period up to 1986. In sum, imported dynamics were important all along, but from late 1986 through to at least the end of 1992 foreign considerations were placed on top of the economic policy making agenda.

The rest of this chapter details the story of how Norwegian economic policy was turned from boom to bust inducing. The first element of the turning operation was to fix the exchange rate, and let interest rates rise to whatever level necessary to defend this rate. This is interpreted as heavily influenced by European experiences and the story of how this happened is the subject matter of section 5.1 with subsections. The other austerity measures put in place were initial steps towards tax reform and a tightening of fiscal policy (section 5.2). Section 5.3 with subsections is about how Europe came to take centre stage. In 1990 the external anchor for exchange rate policy was changed from a trade-weighted basket to the European Currency Unit (ecu) (subsection 5.3.1). About the same time capital controls were liberalised in line with the SEM timetable (subsection 5.3.2). Section 5.4 depicts the banking crisis that the turning operation eventually co-caused. It also shows how this crisis was intertwined with the currency crisis of 1992. How the combined impact of exchange rate and capital control decisions in a changing environment contributed to aggravate the

combined with a meta-theoretical desire to formulate elegant and parsimonious statements these observations inspired what I have called one-sided outside-in explanations. Towards the end of the decade these authors have formulated more complex arguments about the juxtapositioning of structural constraints and domestic choices, see for example (Pauly 1997) and Moses (2000).

domestic economic crisis through sustaining a policy of record-high real interest rates. In the end international currency turbulence caught up with Norway, and unsolicited relief came as NOK was thrown off its ecu-peg. Section 5.5 tries to link the stories presented here more systematically with the theory presented in chapter 2 (section 2.3), while section 5.6 is an epilogue that brings the story up-to date, towards the end of the decade. The main question addressed in this subsection is whether the period of flux is now over, and we can trace a new economic policy regime?

5.1 Fixing the exchange rate – rigid austerity

5.1.1 Preamble: Digesting the reverse oil price shock

In this subsection we shall see that the turning operation was not an immediate response to the oil price fall. As could be expected, perceptions had to sink in, rhetorical traps had to be negotiated, and on the parliamentary arena conflicts over who should govern, and how, had to be resolved before purposeful action could take place. During all this NOK was devalued, and in the aftermath of this dramatic event a new strategy gradually took shape.

The first political actor to react to the income shortage and downward pressure on the NOK caused by the oil price fall, was the Conservative lead Government of Kåre Willoch. Problems were building up fast. The wage round of 1986 was about to be derailed by lockout, to be followed by an extremely generous settlement (see section 3.5 above). While this was going on, the Cabinet was preparing a moderate proposal for a strengthening of the budget in an attempt to make at least some changes towards a more prudent policy stance. Labour, however, was still in opposition, and they probably felt inhibited by their own legacy of persistent rhetoric against any tightening of macro economic policies. As late as in February 1986 their spokesperson on fiscal policy and soon to be Minister of Finance, Gunnar Berge, said the following to Norway's major broadsheet, *Aftenposten*.

It is quite remarkable how the Government is reacting to oil price developments. The fact that the price of oil is a variable is something every Government has to consider, but it is no reason to hit the panic button. The sitting Government has accepted the principle that domestic

economic policy shall not be linked to changing oil revenues. Labour will uphold this principle, also in times when the oil price is falling.¹⁶³

The proposal put forward by the Willoch Government in March consisted of some modest cuts, and time honoured props on the income side. That is, increased indirect taxes on products such as tobacco, alcohol and petrol. The total impact on the budget balance was in the region of 2 billion NOK. For some reason, which is still the object of an unresolved debate, the Government set its position in on the proposition, and was duly felled.¹⁶⁴ Labour argued that the proposal was unacceptable in terms of the groups that would be hit. The Progress party, (on whose tacit support the coalition Government had depended since the election of 1985) would not support “socialist measures” such as increases in the price of petrol (Hanisch et. al. 1999:314).

The Willoch Government left office on the 29th of April 1986, Brundtland’s (second) Government were ready to take over the 9th of May. In the meantime Willoch’s cabinet acted as caretaker Government. The situation seemed more than ripe for a devaluation. In hindsight one can distinguish at least five analytically separable factors that pointed in that direction. The most fundamental expectations driving factor was that the price of oil had plummeted and the current account situation looked bleak. Secondly there was a cabinet crisis. Uncertainty about how well the political system would handle the situation in it itself fuelled speculation. Thirdly, Norway had build up a reputation as a devaluing country over the preceding decade.¹⁶⁵ Under Willoch for example, inflation was again higher than the average for Norway’s competitor countries, and to compensate for this four mini devaluations were made in the space of

¹⁶³ *Aftenposten 16.04.1986*. Quoted in Hanisch et.al (1999:313), my translation.

¹⁶⁴ Kåre Willoch has always insisted that he wanted to remain in charge, while Labour and others have maintained that the Coalition Government was coming apart at the seams over (expensive) pet policies, and that Willoch had no stomach for leading his cabinet through a period that required austerity.

¹⁶⁵ After tracking DM upwards against dollar and yen for three years, Norway devalued 4 times within the “Snake” between 1976 and 1978. Each devaluation was bigger than the last one. It began with 1 percent in October 1976, and ended with 8 percent in February 1978 (Moses 1995:421, table 11.5). Norway left European Monetary Co-operation when plans for the EMS (European Monetary System) were finalised in December 1978, and instituted a trade-weighted basket to stabilise against in stead.

two years. Two of these were camouflaged as technical adjustments, of the trade weighted currency basket Norway had introduced in 1978, and one as “provisional”.

Fourthly these historic devaluations reflected a relative failure of incomes policy. They were most often undertaken with a view to keeping a lid on growth in real disposable income (Erichsen 1999:149). Market actors understood the relationship between incomes and exchange rate policy and because of this the extreme wage settlement of 1986 in it self contributed to downward pressure on NOK. The fifth and last factor was that currency market actors could draw parallels to the situation in Sweden in 1982, when Olof Palme came in with a social democratic government and decided to try and kick-start the economy with a massive, “final” devaluation of 16 percent. This devaluation was meant to be followed by a rigid hard currency approach backed up by fiscal restraint and moderate wage settlements –the so-called third road. In 1986 this policy was still deemed a success by most observers.¹⁶⁶ Given that there is a long history of policy diffusion from Sweden to Norway, market actors had reason to believe that the Swedish experience was closely followed by the leadership of the Labour party.

The 10th of December the NOK was devalued by 10 percent effectively (formally 12 percent). Initially, Brundtland was reluctant to devalue. According to the memoirs of Eivind Erichsen chief official of the Ministry of Finance for almost 30 years (1957-86), her representatives were in contact with the Ministry during the interregnum period. Erichsen’s clear impression was that Brundtland and her advisers would rather wait until they could back up a devaluation with tighter policies all round, Swedish style. Central Bank governor Skånland talked them out of this however. Due to the reasons specified above, market pressure kept increasing, and even unprecedented overnight rates of 50 percent did not stop it. Skånland’s main argument was that the longer the devaluation was postponed the bigger the drain on the currency reserves and the bigger loss for the Central Bank when the devaluation finally came

¹⁶⁶ Particularly after Sweden ran into serious economic troubles in the early 1990’s, more commentators came to view the 1982 devaluation in a less positive light. For a discussion of the process behind, and merits of, the 1982 devaluation see the volume edited by Jonung (1991).

(Erichsen 1999:146). This episode also marks the beginning of a period where Skånland became increasingly influential as advisor to the Government. The policy that gradually took shape was more or less what he had argued for. This transpires when one compares his advice with the strategy that was eventually pursued. Former state secretary in the Ministry of Finance, Bjørn Skogstad Aamo, a key economic advisor to Brundtland, underscores this analysis. His version of the story is that Brundtland took over in a chaotic situation. She was looking for a new economic strategy, and in her choice she was heavily influenced by Skånland.¹⁶⁷ Brundtland has also, if not in so many words, indicated that Skånland's advice was particularly important for her Government in this period (Brundtland 1994:18).

Even so, Skånland did not get his way immediately. In chapter 3 (section 3.4.2), we saw that the Ministry of Finance under Berge continued the practice of “bank-bashing” over retail level interest rates. This was a practice that had first been established when Presthus was Minister. Berge frequently claimed that interest rate levels were going to fall, but kept pushing the time for this to occur further into the future.¹⁶⁸ The Central Bank wanted higher rates, or at least not lower rates, and even allowed itself to disagree publicly with the Ministry (Hanisch et. al 1999:319). The Central Bank also continued to supply short term lending in large quantities. This was done in an attempt to counteract the upward pressure on interest rates that the Central Bank's interventions created (it was buying NOK to defend the exchange rate). This policy, however, was not compatible with the overall strategy of tightening policy in general and cooling off the credit market in particular, and by the end of October it was given up.¹⁶⁹ From then on Norges Bank allowed money market rates to rise (Hanisch et. al. 1999:320).

¹⁶⁷ I owe this information to an interview with Bjørn Skogstad Aamo conducted by my former student and assistant Petter Hveem, 30.04.1997. See also Hveem (1997:76-78).

¹⁶⁸ In the spring of 1986 Berge said rates would come down that autumn, in the autumn he talked about next spring and in the summer of 1987 he was hoping for rates to come down later that year which in the autumn was shot out to next year. In the autumn of 1987 Berge added that he had never promised lower interest rates (!) *Aftenposten*, 11.12. 1987, (quoted in Lie 1998:95)

¹⁶⁹ Indeed had Norway had a fully liberalised currency market at the time, the mix between interventions to support the NOK and generous short term lending would have seemed totally

Towards the end of the year, however, the turning operation” began to look like a consistent strategy. The next subsection will be devoted to the new European inspired hard currency approach that was chosen, implying a very tight monetary policy. In the next full section (5.2), I will look at how tax reform and fiscal policy contributed to austerity.

5.1.2 Hard currency and high interest rates

In this subsection I describe how the Central Bank convinced Government that an uncompromising exchange rate policy should be pivotal in future macro economic management. I also seek the intellectual roots for this advice in a broader European context.

During the autumn of 1986 the NOK came under pressure on several occasions. In December the decision to defend its value at all costs were made, and the Central Bank marked the occasion by raising overnight rates to 16 percent (Skånland 1996). The most immediate motive behind the new stance was that the devaluation of May that year had been so large that this in it self precluded further tampering with the exchange rate. Otherwise Norway would loose any remaining credibility in the foreign exchange market.¹⁷⁰ But this was a very serious decision with ramifications far beyond exchange rate policy per se.

In short, exchange rate policy became the centrepiece of a new macro-economic strategy. Because of Norway’s devaluation history and the current account deficit, defending the currency entailed keeping interest rates much higher than the European average. In 1987 and 1988 Norwegian rates were about 6 percentage points above a trade weighted European average (NOU 1989:1, table 5.6 and 5.7). Thus the Central Bank was finally secured interest rate levels that could have at least some effect on

incoherent. Because, in this scenario, the borrowers of NOK would have been free to exchange their funds into foreign currencies thereby undermining the Central Bank’s attempt at supporting the exchange rate target. With the explicit aim of making it easier to defend the NOK, *Norges Bank*, did tighten regulations on short term capital movements through several measures implemented from late 1985 to late 1986 (Hveem 1997:51-52), see also subsection 5.3.2 below.

¹⁷⁰ Interview with Hermod Skånland 03.12.99.

credit demand. And it ended the practice of hampering the Central Bank's execution of monetary policy with political concerns how high money market rates could go. This way *credit supply* was also addressed more directly. Quite simply, a 40-year old political tradition of regulating the rate of interest downwards was given up (although bank bashing for purposes of political blame avoidance was, as we saw in subsection 3.4, not given up). It was also part of the new strategy that private borrowing should cover the current account deficit. Thus long term capital flows were liberalised, while regulation of short term movements were tightened somewhat (see subsection 5.3.2, below).

The theory informing this change of exchange rate regime is known as vicious cycles theory. The central proposition here is that a devaluation to improve competitiveness only works in the (very) short run. In the long run it is counterproductive. This notion hinges on two arguments. The first of these departs from the real economy, the other from the financial sphere. The argument based on the real economy is that inflationary pressures will soon worsen rather than improve the competitive position of the economy that devalued. At least three mechanisms are of importance here. One is that wage settlements will compensate (or, depending on the degree to which rational expectations are imputed - even anticipate) the reduced purchasing power of the currency after devaluation. The second is that in a highly trade dependent economy, the increased prices of imported goods will also yield inflationary pressures. The third is that exporters will often prefer to defend their prices in foreign currencies in stead of reaping the gains in the form of defending or even increasing their volumes. Similarly, exporters who price their goods in the local currency could be expected to let their prices rise after a devaluation. Indeed, immediately after the 1986 devaluation Norwegian exporters seemed to do just this as export volumes fell and prices increased from the second to the third quarter of that year.¹⁷¹ By behaving in such a manner exporters could prevent the desired adjustment of relative prices, and (instead) contribute to the inflationary process (Loriaux 1991:28-31). The argument

¹⁷¹ "Økonomisk oversikt", Penger og kreditt 4/1986:379, quoted in Hanisch (1999:320).

departing from the financial sphere, is that when a country gets a reputation for being “soft” on devaluations, investors will demand a risk premium for staying in its currency, thus pressing interest rates upwards.

The policy prescription that follows from the vicious cycles analysis is to defend the exchange rate at all costs, and gradually reap the rewards in the form of lower inflation, increased investor confidence, lower interest rates and improved competitiveness. As was pointed out in subsection 2.2.3.3 (above), this analysis can be seen as one specific solution (particularly attractive to small trade dependent economies) to the more general problem of establishing transparent rules for monetary policy in order to avoid sparking inflationary expectations. In line with this a “new” language was invoked. Words like “norms” (for the currency that is, not human behaviour as such) long term and stability, got a more central place in the Norwegian political economic discourse. (Greek) shipping (history) became a main source of metaphors as it was spoken of tying oneself to the mast, and of the exchange rate as a nominal anchor. Uncompromising rigidity was recommended. No noticeable attention was being paid to the possibility that in changing circumstances rigidity could be a source of great instability.

The adoption of this analysis by the Central Bank economists can be traced to at least two sources, one on the “demand side” and one on the “supply side” of the learning process. On the “demand side”, one can see that the new regime held a promise to provide answers to long standing problems that were perceived as acute by the Central Bank. The interest rate issue, inflation and lost cost competitiveness were all central to the bank’s concerns. Hermod Skånland had argued that pursuing a “durable equilibrium” (*varig balanse*) should be the main goal of economic policy, quite a while before he got his way in December 1986.¹⁷² For Skånland a durable equilibrium roughly meant that the neither the state, nor the nation as such, should consume more resources than there was real economic cover for. In practical policy

¹⁷² In *Norges Banks* recommendations to the new Central Bank act of 1985 it said that special emphasis should be put on achieving a “durable equilibrium in the nation’s economy” (Skånland 1986:44). See also Skånland (1987:140).

this translated into a fiscal policy that was sufficiently tight to curb inflationary expectations so that it could support exchange rate policy. If we turn this around we see that it entails an invitation to the market to discipline democratically elected politicians. In theory at least, politicians should be “punished” by the market through downward pressure on the exchange rate and thereby higher interest rates, if they are “weak” when formulating fiscal policy.

On the supply side of the learning process, developments elsewhere in Europe seemed to validate the theory behind the analysis. Hermod Skånland remembers following the Danish experience under Conservative Prime minister Schlüter with particular interest.¹⁷³ Up until Schlüter took over in the autumn of 1982, Denmark had, much like Norway, gone through a six year period of creeping devaluations. Because of chronic problems on the current account (unlike Norway) Danish policy had fallen into a stop-go rhythm, switching between expansion through fiscal policy and contraction primarily driven by high interest rates needed to attract foreign capital to finance the public deficit (Mjøset 1986: 241). Investors demanded a premium, and interest rates established themselves at very high levels. Between 1980 and 1982 the yield on government bonds was around 20 percent. With the exception of one year unemployment grew steadily from 1973 to 1982. Inflation was around the 10 percent mark or higher throughout this period.

Schlüter’s government broke these trends and the centrepiece of his strategy was an uncompromising attitude towards the exchange rate. On two occasions after Schlüter took over the Danish krone withstood serious speculative attacks through massive interventions and short- term interest rates around the 30 percent mark (Moses 1995:333-335). The Schlüter cabinet also cut public expenses and increased taxes. After a turbulent first year, the strategy gained credibility. Long term interest rates fell to 15 and then 12 percent, inflation came down and unemployment levels fell. It is debatable how much credit Schlüter’s strategy should be accorded for these developments (Mjøset 1986:246), but the orthodox interpretation soon became that

¹⁷³ Interview with Hermod Skånland 03.12.99.

Schlüter had got most things right, and it became a commonplace to speak of the “Danish miracle” (Moses 1995:336).

Farther south in Europe, vicious cycles was also a big topic among French planners and economists from the mid-seventies and onwards (Loriaux 1991:28-31). This is not surprising given France’s own experience. After the breakdown of the Bretton Woods currency regime, the country went into a cycle of frequent devaluations and higher inflation than most other industrialised nations. Great Britain and Italy displayed a similar pattern during the 1970’s. Proponents of the theory could find further support by considering the cases of Switzerland and more importantly, West Germany. Both these countries were characterised by strong appreciating currencies, low inflation and excellent export performances. This was interpreted as virtuous cycles.

During late 1982 and early 1983 the president of France, Francois Mitterrand, made his famous U-turn. His original programme had included debt-financed reflation, redistribution and nationalisation, all undertaken with an overvalued currency in a world economy in recession. Short-term growth and employment performance was good. But Mitterrand’s policies also led to rampant inflation, rapid deterioration of the trade balance, capital flight and three devaluations within less than three years. Seemingly, the vicious cycle was getting shorter and more vicious. Heavily influenced by his Minister of Finance, Jacques Delors, Mitterrand steered the socialist party on to a course that gave top priority to monetary co-operation within the EMS and the kind of inflation performance this demanded. The so-called *franc fort* was established (McNamara 1998:137). This course was chosen even though it came at the cost of tough austerity measures. Some of these measures were, humiliatingly enough, more or less dictated by the West Germans. The Germans gained leverage since every devaluation of the franc in reality was an adjustment of the bilateral relationship with the Deutsche Mark (Cameron 1988:46-53). The Mitterrand Government also changed course in structural policy. Going from increasing interventionism to liberalisation (Loriaux 1991:217-222).

After Mitterand's turn, the EMS entered into a more stable period (Gros and Thygesen 1992: 83). What McNamara (1998) has dubbed the "neo-liberal policy consensus" gradually took hold among the member countries. Roughly speaking this implied that they accepted West Germany as a model of monetary management and that they all put inflation fighting first. The EMS was gradually strengthened as a result. Adjustments were fewer and smaller. Member countries relied relatively less on interventions and capital controls and more on interest rate policy in their exchange rate management. Between 1983 and 1986 EMS inflation performance improved dramatically, the average EMS rate of inflation was cut in half to 4.6 percent. This compared favourably with both previous periods and with other European non-EMS countries (Gros and Thygesen 1992:112).

5.2 The rest of the policy package

We have seen that the fixed exchange rate was the centrepiece of the new macro-economic strategy. In the following two subsections the rest of the policy package that made up the turning operation is described. As we shall see fiscal and incomes policies (subsection 5.2.1) were successfully redirected so as to serve the purpose of dampening aggregate demand. But within these issue areas policy change did not have extreme effects. Fiscal policy was even loosened when signs that the contraction was going too far began to appear. In tax reform (subsection 5.2.2), however, no such flexibility was allowed. This was a structural reform. It had been time-consuming and difficult to get in place, and it was intended for the long term. This must be part of the reason why no one suggested tampering with this reform for short-term purposes, even if it came at the cost of contributing to a real interest rate shock.

5.2.1 Fiscal and incomes policy – moderate moderation

In spite of the turbulence surrounding the change of government in the middle of the process, fiscal policy was in fact tightened after Parliament had processed the revised national budget for 1986 that year. Expenditure was cut and both direct and indirect taxes were increased. A tight fiscal stance was maintained throughout 1987.

The result was a big surplus on the structural budget balance for both of these years. This indicator still showed a surplus in 1988, although a smaller one (NOU:1992:30: figure 2.3.2).¹⁷⁴ During 1988 it became clear that unemployment was on the rise and that domestic demand was falling rapidly. This motivated a more interventionist approach to wage settlements and a relaxation of fiscal policy.

The Government entered into talks with the LO and the NHO and against a back-drop of increasing unemployment, moderate wage settlements were achieved for 1988 and 1989. What the Government did was to generalise the LO-NHO settlement to the rest of the labour market by law. According to econometric estimates the settlements of 1988 and 1989 resulted in wages being between 4 and 8 percent lower than they would otherwise have been (Rødseth 1997:180). The following years up until 1994 also saw moderate settlements (Dølvik et. al. 1997:92).¹⁷⁵ These efforts contributed to an improvement in Norway's competitive position, helped bring inflation downward, and thus lent support to the fixed exchange rate.

Fiscal policy turned expansive from 1989, peaking in 1992, as measured by the structural budget balance. The municipalities got bigger transfers and labour market policy received better funding while spending on public construction was increased (NOU 1992:30:63). How expansive fiscal policy really was is a matter of debate. Retrieving an argument originally put forward by Statistics Norway, Hanisch et. al (1999:333) point out that when one measures fiscal policy by the structural budget balance the costs of an active labour market policy are not deducted. In Hanisch's opinion such costs should be seen as cyclical and should therefore be left out. If one does this, the impression of fiscal policy as being decidedly counter-cyclical in this period is somewhat dampened. This is not a major point in our context, however. The main point is that when the recession set in, in 1988 (BNP showed a negative growth rate in that year, see section 5.4 below), fiscal policy was almost neutral. In fact, fiscal policy had a positive impact on aggregate demand as early as 1989. In hindsight one may well argue that fiscal policy could have been more expansive and the stance could

¹⁷⁴ See chapter 3 (section 3.5) for an elaboration of the concept of structural budget balances.

have been changed a little earlier. Still, its contribution to the recession was not great. Tax reform, however, had a much greater role to play, and this will be dealt with in the next subsection.

5.2.2 Tax reform – real interest rate shock

The key point in this subsection is that the crisis on the current account and the ensuing “turning operation” also contributed to untying the Gordian knot of what to do with tax breaks on interest rates and the tax system in general. Furthermore, this contributed substantially to producing a real interest rate shock a couple of years later. From the discussion of the stickiness of tax policy in chapter 3 (subsection 3.4.1), two points can be carried over. Firstly, that tax policy is inherently sticky because it is complex and includes many privileges. This gives many players reason to oppose reform for partly different reasons. Secondly, as the issue of the deductibility was processed and debated during the first part of the 1980s, the Conservative party was gradually more and more isolated in its stance against change. This opposition was crucial while the party held the post of Prime minister, but now, as of May 1986, Labour was in power. In the budget for 1987, Labour actually succeeded in shifting some of the tax burden over from net to gross income. This allowed for a decrease in marginal rates on net income, which translated into the state covering proportionally less of peoples interest rate expenses.

In 1986 the marginal tax rate for those in higher income brackets was 66,4 percent, which meant that the state in reality covered two-thirds of the interest rate expenses of this group. The rate for middle incomes was 45 percent. For 1987 the corresponding rates were 56% and 41% respectively (NOU 1989:30:table 5.7). By 1987 inflation was increasing so rapidly that this did not have a significant effect on after-tax real interest rate costs in the economy. As we saw in chapter 3 (subsection 3.4.2) the boom, and consequently overshooting of the Government’s credit target, continued into that year. By 1988 things were about to change, however. Real post-tax interest rates started a steep climb. There are three variables in the equation behind real

¹⁷⁵ The wage rounds from 1993 and onwards will be discussed further in section 5.7 below.

after-tax rates. Inflation and the value of tax breaks (both of which fell thereby bringing real rates upwards year by year until 1992) were the two variables undergoing significant change in this period. The third variable, nominal interest rates, remained stable and high enough throughout the period not to significantly compensate for the effect of change on the first two variables.¹⁷⁶

The reason that the value of tax breaks could fall every year until 1992, was that a broad based compromise on tax policy was reached in the spring session of Parliament in 1987. Harald Synnes, a Christian Democrat, chaired the work of the “Finance-committee” of Parliament on the Government’s report on tax policy. He has described this work himself in an article published in a *festschrift* one year later (Synnes 1988). Several points of interest for the present analysis emerge. Firstly, the chairperson observed that *Stortinget*, had very little time available for such a complex set of question. For this reason he had to prioritise strongly among the issues. He mentions four substantial priorities. In effect, three of these have the same focal point: to reduce marginal rates on net income so that the distortion the cost of borrowing was subject to in the old system would be “eliminated”.¹⁷⁷ Synnes also placed great value on establishing a broad based compromise. In order to achieve this, his first tactical priority was to establish a dialogue with the Conservatives, then the Centre Party, the other former coalition partner of the Christian Democrats (Synnes 1988:103-104). After some initial scepticism, both these parties started to pull in the same direction. The willingness of the Conservatives to finally address the issue of deductibility is particularly interesting, given the party’s record of opposition.

¹⁷⁶ In 1986 the average lending rate for Norwegian banks was 16.1 percent in 1992 it was 14.3. (Historisk Statistikk table 24.23).

¹⁷⁷ Synnes (1988:103) divides his four point agenda in the following manner. 1) Reduce distortions – and the social injustice that resulted from a system where high income was associated with high marginal tax rates and thus large deductions. 2) To refute the kind of large scale transition to tax on gross income that the “tax commission” had recommended. 3) To reduce the highest rates of marginal tax so that less energy would be spent on tax-motivated transactions and investments. 4) To reduce the scope for tax-deductible expenses so that a wider tax-bases could be established. We see that points 1,3 and 4 are intimately related. 1 and 3 basically give different motivations for doing the same thing (reduce marginal rates) while 4 was a necessary step if one wanted to achieve this without affecting revenues negatively.

Synnes' detailing of his efforts leaves one with the impression that the Conservative Party had several reasons to play along this time. Firstly, because by the time this was debated in the spring of 1987, it was clear to politicians in the "Finance committee", that the Norwegian credit market was out of control. It was equally clear that this had a lot to do with real interest rates and that the overheating this led to contributed to the precarious situation on the current account. Secondly, at this time, the three former coalition partners were still harbouring very concrete dreams of forming a government together again. If this was to be achieved some unity on the tax issue would be a great advantage. Thirdly, and most simply, the Conservative party was being pampered. This was most probably a wise move on the part of the chair. Strategically it was advantageous to secure the co-operation of the most recalcitrant party first. Having done this he could then move on to parties that had already signalled a stronger willingness to reduce the value of tax breaks. It was not an appealing proposition for other parties, and for Labour in particular, to be seen as the party that killed the tax reform, after the Conservatives had finally come out to play.

Gradually a broad consensus was hammered out, including even the Socialist Left Party (SV), which had been sceptical because the strategy of reducing the value of deductions through reducing marginal rates made the tax system less progressive – at least nominally. Thus only the Progress Party, which wanted a completely flat tax rate, with 20 percent rates on net income and a further 12 on gross income, declined to subscribe to the compromise (Synnes 1988:108). The compromise involved immediate action, but also set out parameters that allowed the parties to reach agreement on a complete overhaul of the tax system by 1992. The solution reached in 1987 also implied that marginal rates were pushed downwards for all but the lowest income groups for every year, until it ended up at 28 percent across the board in 1992. In 1988 real post tax rates became positive, also for high-income groups, for the first time since the early 1960's!¹⁷⁸ As inflation came down and nominal rates stayed high, real, post-

¹⁷⁸ In 1960 the average lending rate in Norway was 4.8 percent while inflation was registered as zero. In 1961 it was 4.9, while inflation was 2.5. I don't have the marginal tax rates for high-income groups for these years, but in 1960 at least, after-tax real interest rates were obviously positive. In many of the later years inflation actually surpassed the average interest rate, which means

tax interest rates skyrocketed. In 1986 real post tax rates had varied between +1,3 for average incomes and -1,8 for higher income groups. It was approaching +3 percent for average incomes in 1988, 5 percent in 1989 before it peaked at around 7 percent towards the end of 1992 (Storvik 1998:71, figure 8), the year when all income tax payers got a uniform marginal tax rate on net income.

The real interest rate shock affected economic development. As already stated, from 1988 the economy went into a recession, that soon turned into a depression. That is: negative GDP growth, increasing unemployment, asset price deflation and a wave of bankruptcies. In section 5.4, this depression will be described in more detail. Before I get to that, however, the process whereby the monetary sphere was further Europeanised will be described.

5.3 Europe takes centre stage

We have already seen that the exchange-rate centred solution sought in 1986 was influenced by European experiences and a given theoretical interpretation of these. It was also as early as in 1986 that the Norwegian government, with the backing of Parliament, established as a general principle that it wanted to harmonise Norwegian policies with the Single Market scheme (Farsund and Sverdrup 1994:55). The years between 1988 and 1994, however, saw European issues increasingly dominate the Norwegian political agenda. These were the years of EEA initiative and EEA and full membership negotiations. In 1988 prime minister Brundtland issued a letter to the ministries stating that when writing new rules and regulations within issue areas covered by the internal market, this should be done with a view to harmonisation (Brundtland 1998:166). In the winter of 1989 the EEA process got under way. After Syse's one year stint as Prime-minister from October 1989 was ended, the returning

that real interest rates were negative even before taxes and deductions are brought into the equation. In the late 1970s this changed however, and real interest tended to be positive before taxes were brought in, but still both high and average incomes enjoyed negative post-tax rates, although high income groups more so than those with average income. From 1984 up to and including 1987 only high-income groups enjoyed negative post-tax rates. Sources Historical Statistics 1994: Table 24.23 and NOU 1989:1:table 5.7).

Brundtland repeated her message about preparing for the EEA in a letter to her ministers in November 1990 (Brundtland 1998:167). In 1992, the EEA negotiations were finalised. Following the example of other EFTA-countries such as Austria and Sweden Norway applied for full membership and negotiations about this took place during 1993 and the first part of 1994.

Thus the period from 1988 to 1994 was one of intense concern with, and debate on, the merits of European level regimes. If we use political attention as our indicator, it is fair to say that the referendum over full membership of the 28th of November 1994 marks a watershed. Seen from the viewpoint of monetary policy, however, the most important date was the 10th of December two years earlier. That day the Government and the Central Bank decided to free the NOK of its ECU peg. One of the prime reasons why they felt compelled to do this was strong speculation against the NOK, facilitated by the earlier decision to lift remaining capital controls in line with the timetable for the Internal Market. In this section exchange rate management (5.3.1) and capital controls (5.3.2) will be dealt with in this order.

5.3.1 Changing the anchor – importing European interest rates

This subsection describes and explains why the nominal anchor for the exchange rate was changed from a trade weighted basket to the European Currency Unit – ECU. It is also argued that this switch, rather than solving the problems that at least partly motivated it (lack of credibility and too high interest rates), actually aggravated them. Norway hooked on to the European Monetary System (EMS) just as this ran into a turbulent period.

As we have seen the decision to switch to an uncompromising fixed exchange in December 1986 was a dramatic one. It had all-round ramifications for Norway's macro-economic policies. The politically most potent was that it ended 40 years of regulating the rate of interest downwards. The decision was never marketed as such, though. It was slipped in, discretely, without any public debate, and confirmed through actions and statements in the aftermath of the decision being made (Moses 1995:350).

In his lecture to the economist convention, quoted above, the Central Bank governor spoke of how interest rates were now tied up in defence of the NOK (Skånland 1987:136-137). This is the closest I have found to a public confirmation of the new strategy. In stead the Labour government preferred to focus on the severity of the situation. When speaking of the “turning operation”, Minister of Finance Gunnar Berge would typically underline the need for each and every Norwegian to support the domestic economy for example by holiday making at home in stead of (spending currency) by flying off to southern lands.¹⁷⁹

Politicians were less enthusiastic about explicitly defending the need for higher interest rates. Indeed, as we saw in chapter 3 (subsection 3.4.2), the political scramble to avoid blame for raising interest rates continued also after 1986. And when the higher rates were addressed, they were spoken of as unavoidable, as forces of nature even, not as the active choice of one option among many. An illustrative example of the mood among politicians that had come to accept vicious cycles theory and its implications for Norwegian policy making, can be found in a quip made by then deputy Labour leader Einar Førde. In 1987 he said, “to decide politically that interest rates must come down, is like deciding that the herring shoals should return to the west coast”.¹⁸⁰

The situation was politically awkward. All major parties participated in the “turning operation”, but some of its implications were deeply unpopular. In chapter one we saw that “Renteutvalget” was established as a response to the provisional freeing of interest rates which led to a hike of two percentage points in the autumn of 1977. The Labour Government in power in 1987 instigated a similar move. The new macro-economic strategy needed post hoc democratic and technocratic legitimacy bestowed upon it. For this purpose a large committee of inquiry was set up in June 1987. Their task was to analyse the full spectre of monetary policy issues, ranging from the state banks, via taxing to the core issue, choice of exchange rate regime. Also in

¹⁷⁹ I have not tried to trace written sources on this point. But I was reporting on economic affairs for Norwegian radio at the time, and have a clear recollection of Berge making such and similar statements on several occasions.

¹⁸⁰ Quoted in Lie (1998:95), my translation.

keeping with the tradition of “Renteutvalget”, a veteran Labour politician and former finance minister with a track record as a staunch interventionist and keynesian, in this case Per Kleppe, was asked to lead the committee. Otherwise the full spectrum of political parties and business, labour and banking organisations, and academia were represented.

The resulting report “Penger og Kreditt i en omstillingstid” (NOU 1989:1) is a rich document. Several issues are analysed, drawing on a big load of commissioned research and data. Most importantly, the committee “confirmed” that the new hard currency strategy was a wise one, defending the decision by means of economic analysis. It also, however, brought the agenda forward. Two conclusions stand out. One is a carefully phrased recommendation to establish a link of some kind to the EMS. The other (which will be discussed in subsection 5.3.2), is a recommendation to scrap remaining capital controls. In short, the committee recommended a Europeanisation of the Norwegian financial sphere.

By the time the committee had handed over its report in February 1989, the political costs of high interest rates and the on-coming depression were getting higher. Therefore it was important that the committee argued that Norwegian interest rates could be expected to come down if Norway sought an association with the EMS (NOU: 1989:25-26). The argument was built on the logic of vicious cycles theory. More specifically the report said that such a move would increase the credibility of the Norwegian commitment and thus help bring the “risk premium” down. As a part of this argument the committee envisioned that co-ordinated interventions and short-term credit lines from other central banks could strengthen the hard currency approach.

On the other hand, the committee also saw arguments against linking up to the ecu. The most important counter-argument was that the ecu – by definition - to a lesser degree than a trade-weighted basket could reflect the composition of Norway’s exports and imports. But, the EEA process was under way (see below) and the committee noted that as the Norwegian economy responded to this, the share of the EC in Norwegian trade could be expected to go up. It was also quite possible that important trading partners such as Great Britain and Sweden would join the EMS. This would, if

it happened, reduce the difference between a basket and the ECU “substantially”, according to the committee. Having said this the committee had to be mindful of the fact that the EC/EU issue was (and still is) highly sensitive in Norway. The conclusion to this section was therefore suitably modest:

A link to the EMS should be taken under consideration with due attention paid to the factors mentioned here.¹⁸¹

The Finance committee in Parliament discussed preliminary drafts from the report when the budget for 1988 was being revised that spring. This discussion revealed that the Labour Government would have had a parliamentary majority behind it, if it sought an association with the EMS. It also showed that this majority thought future British choices relevant for the Norwegian decision (Dobloug 1992:100). After the general election of September 1989, however, Norway got a new Government, led by the Conservative and EC-membership supporting Jan P. Syse. This was a three-party coalition and the two other participants were the Centre Party and the Christian Democrats. These two parties were deeply and moderately Euro-sceptical respectively. In other words: the coalition was potentially combustible with respect to EC-issues.

On the 5th of October 1990 Great Britain decided to tie the pound to European monetary co-operation by joining the Exchange Rate Mechanism (ERM). The Syse cabinet seized the political opportunity this somehow presented. On the 19th of the same month the NOK was linked to ecu at par of exchange. That is the Norwegian currency joined at the same rate as it left the basket. No formal association with the EMS was sought at the time, it was a unilateral action on Norway’s part.¹⁸² It is interesting that the pound joining ERM could trigger Norway’s decision to link up to the ecu. It is interesting because the argument for the pound’s significance for Norway’s situation is a flimsy one. The crucial point is that by 1990 the ecu was calculated on the basis of all EC-currencies, not just the ones that participated in the

¹⁸¹ (NOU 1989:1:27), my translation.

¹⁸² Agreements on co-ordinated interventions and credit lines with other central banks were put in place later.

ERM.¹⁸³ This means that the British decision to join the ERM did not substantially impact the degree of bilateral stabilisation that could be achieved between NOK and the Pound when one compared the two alternatives Norway were considering, that is the trade weighted basket and a link to the ecu.

This indicates that either leading politicians did not master the technicalities involved in the decision they were making, or that some of them had a different agenda. It is tempting to say that there was a bit of both. By October 1990 the issue of Norway's relationship to the EU was heating up. For the strongest party in the coalition government, the Conservatives and for the leading opposition party, Labour, both pro-membership parties, it seems plausible that the decision to link up to the ecu was as much about Norway's relationship to the EC as it was about economic expediency. The Conservative minister of finance, Arne Skauge, was quite frank about this when concluding his statement to Parliament the evening that Norway joined:

We also find that this is an appropriate time to give a hint to those bodies that are now preparing a treaty conference on a further development of monetary co-operation in the EC.¹⁸⁴

How the staunch no-people of the Centre-party – who would break up the government on another EC-issue nine days later – could accept the ecu-link is hard to understand.¹⁸⁵ It is of course possible they did not really scrutinise the technical details of the “pound-argument”. It had after all been printed in the report of a broad based commission brimming with expertise on the issue. Another factor influencing all the politicians that supported the ecu-link is that Skånland was understood to be for it. As has been pointed out above, the Central Bank governor's influence on exchange rate issues had been considerable since the days of Willoch, and it grew during the post 1986 “turning operation”. Skånland himself says that he deliberately kept a low profile on the ecu-issue. This was because he tended to see the choice of anchor as a means to a greater end - that there would be an anchor at all. His attitude could be summed up

¹⁸³ The British pound had been included since July 1979, Greece joined in 1986 and Spain and Portugal 1987 and 1988.

¹⁸⁴ St. forh. (1990-91):393, quoted from Dobloug 1992, my translation.

¹⁸⁵ The Syse-government resigned the 28th of October 1990, basically because the Centre Party could not accept being part of a government that would have to repeal or at least substantially water-down Norway's concession-laws as part of the EEA process, see Tamnes (1997:232).

this way: if an ecu-link was what the politicians needed to be able to stick to the fixed exchange rate, then so be it.¹⁸⁶

Most probably though, the vicious cycles based “promise” of lower interest rates was the decisive factor that made the Centre Party support an ecu-link. Ever since the debt crisis in agriculture in the inter-war period “Bondepartiet”, (i.e the “Farmers party”, which later changed its name to the Centre Party), had been the party most interested in keeping interest rates down. Average interest rates in the “basket-countries” had risen since 1988. This had raised the “floor” for Norwegian nominal interest rates. Subsequently they did not fall as much as Norwegians policy makers would have hoped during the 1988-90 period. In stead the interest differential was narrowed in from below. A disappointing development given that both Norway’s inflation performance and the current account improved. The current account was back in the black in 1989.¹⁸⁷

Norwegian politicians, and the net debtors among their voters, were in for further disappointment. In hindsight one can make the case that committing to the ecu contributed to higher interest rates than what would otherwise have been the case. This argument can be made because when a small country stabilises its currency against other currencies, this implies that the small country to a certain degree imports interest rates from the countries whose currencies the small country is stabilising against. The key aspect of the changeover in baskets is that linking to the ecu implied not stabilising against the dollar. In turn this meant that the DM and subsequently (West)German monetary policy had an even greater bearing on Norwegian monetary policy.¹⁸⁸ Both

¹⁸⁶ Interview with Hermod Skånland 03.12.99.

¹⁸⁷ In 1988 average interest rates charged by Norwegian banks were 16.8 percent. In 1990 they were 14.7. In the same period inflation came down from 6.7 percent to 4.1. Combined with the reduction in tax deductibility of interest rates this resulted, as we saw in subsection 5.2.2, in real post rates increasing year by year.

¹⁸⁸ The US dollar made up 11 percent of the old trade-weighted basket in 1990. This was disproportionate compared to US-Norwegian trade, but was meant to partly reflect the importance of dollars as medium of exchange for trade in oil and shipping services. The DM went from 17.7 to 30.3 percent after the changeover in baskets.

directly through its increased weight, and indirectly because (West) German monetary policy totally dominated the ERM.

By October 1990, when the ecu-link was made, international developments were, seen with Norwegian eyes, taking a turn for the worse, which resulted in Norwegian nominal rates remaining high. The American economy was going into recession. Subsequently both American interest rates and the dollar fell. Norway could have reaped some, if limited, benefit from this if NOK had still been stabilised against a basket including the dollar. In stead Norwegian interest rates and the NOK followed German interest rates and the DM upwards. From mid-1989 to early 1991 the interest rate differential between US dollars and DM changed by more than five percentage points. US short term rates went from being 2.8 percentage points higher to being 2.6 percentage points lower than those in Germany (Marris 1995:11). In the same period the dollar weakened substantially against DM.¹⁸⁹ This means that – all other things equal – the floor for Norwegian interest rates were higher and that the exchange rate rose measured against the old basket.¹⁹⁰ At this point Norwegian banks were in serious trouble and unemployment was on the rise. Domestic considerations would therefore have suggested lower interest rates and preferably a lower exchange rate, but in 1990 and the first part of 1991 europeanisation implied the opposite.¹⁹¹ Towards the end of 1991 the relationship between DM and dollars again turned, but the interest rate differential continued to widen, and soon Norway would be caught up by the trouble that was brewing in the EMS. The Central Bank therefore had to continue and as the situation heated up, even reinforce its policy of high interest rates. The 1990-1992

¹⁸⁹ The dollar fell by 28 percent measured in DM (Marris 1995:11).

¹⁹⁰ The rise of the so called effective exchange rate can be seen in Alstadheim (1995:49, figur 2.4).

¹⁹¹ This argument is not undisputed. Leif Eide (1992), a director at *Norges Bank*, evaluated the effects of the ecu-link in an article published before the ERM debacle came to a head and Norway was pressured out of its commitment in December 1992. His arguments were firstly that swings in the DM-Dollar rate are short-term phenomena and can thus be accorded little weight when choosing exchange rate targets. Secondly, he argued that “the market” quite possibly charges a lower risk premium from countries that bind themselves to a multilateral regime compared to those who utilise a “home-made” basket.

period therefore stands out as one of pro-cyclical monetary policy: high interest rates in an economic downturn.

5.3.2 Liberalising capital controls - an internal market for money

The optimism that followed from 4 years of successfully defending an uncompromising exchange rate policy made it easier to go through with a full liberalisation of capital controls. Ironically, this choice in turn made it harder and more costly in terms of both interest rates and currency interventions to defend the exchange rate when trouble set in, in the autumn of 1992. I will return to these troubles in the subsections 5.4.2, and 5.5.2 below. This subsection, however, is devoted to telling the story of when and why capital controls were liberalised.

In chapter three (subsection 3.4.2) we saw that *Norges Bank* in 1979 inadvertently created a loophole that the banks could take advantage of to borrow abroad in the first part of their hyper-growth period (1984-85). We also saw that when confidence in NOK fell after the reverse oil price shock of 1986, the Central Bank felt compelled to replace this funding. None of these events got any political attention at the time when they occurred. Capital control is a technically complex issue area with low visibility. Its merits are more often debated in central banks and international expert dominated forums like the IMF, OECD and eventually the European Commission, rather than on the national democratic arena. Still, as the episode of 1984-86 illustrates, this policy field is of great importance because of its supporting role for both credit and exchange rate policy. In Norway, as in most other European countries, the historical rationale for capital controls established in the immediate post-war period had been that they made it possible to shelter the domestic allocation of capital, stabilisation policy and the domestic interest rate from international developments.¹⁹² Smaller volumes of foreign exchange transactions also made it easier

¹⁹² Conceptually capital controls (controls that cover transactions on the balance of payments) can be distinguished from exchange controls (controls that cover trade related payments). Exchange controls were mainly employed to ration currency (and thus the allocation of real goods) during reconstruction after WW2. These were in the main lifted when European currencies again were made convertible against US dollars in 1958 (Cohen 1977:97, Hveem 1997:41).

to defend a given exchange rate level by way of the interest rate and interventions in the market for one's own currency.

After 1986 the credit policy argument had lost its relevance. Norway had a liberalised credit market and high interest rates were deemed necessary to defend the currency and thereby obtain lower interest rates in the "long run". The argument related to exchange rate management - that capital controls on short term movements can make it easier to defend a given exchange rate level - was still relevant in 1986. In principle most (government) economists had lost faith in all capital controls by this time, but they were still useful in as much as they could throw some sand in the machinery of international capital markets. Therefore the Ministry of Finance with support from Central Bank governor Skånland, initiated a moderate tightening of exchange controls in the futures market, at the same time as short term interest rates were hiked to 16 percent in December 1986 (Hveem 1997:86-88). The argument was further that this was a situation of extreme imbalances in the Norwegian economy, and that it should be considered a temporary measure.

By the time the commission led by Per Kleppe was nearing its conclusion the economic indicators that influence the exchange rate most heavily were boding well for the hard currency regime. The current account was moving towards the black and Norwegian inflation was converging with European rates. This meant that the reasons given for keeping (and strengthening) controls on short-term movements were gone. In fact the argument could be driven to the opposite extreme. Given that the "fundamentals" (i.e. inflation and the external balance) of the economy are not in total disarray, it could be argued that by opening up for international capital movements, a state can increase its credibility vis-à-vis market actors. The point being that when a state willingly increases its exposure to the market, it signals that it has serious intentions. At the same time the sitting government creates a structural constraint on future - perhaps more spendthrift - governments. Thus we recognise the logic that flows from the pessimistic view of democratic politics discussed in subsection 2.2.3.3, above.

At the same time the Internal Market process provided a powerful dynamic. According to the EC's directive on capital controls, remaining such were to be

removed within 1.7.1990. The main argument here was consistent with the now established neo-liberal hegemony in the international economics discourse. During the Bretton Woods negotiations Keynes had successfully argued for an interpretation of international capital movements as detrimental for the real economy and Government's ability to manage it.¹⁹³ The Bretton Woods order legitimised and provided a rationale for capital controls. Capital controls were means for, literally speaking, real ends. In addition to facilitating domestic monetary autonomy, they were also held to facilitate trade through facilitating stable exchange rates (Helleiner 1994). Now mobile capital was conceptualised differently. Basically the distinction between the real economy and the finance economy (or the "economy of fiction" as the leading Oslo-school economist Ragnar Frisch liked to call it) insisted upon by the keynesians, was ignored. Now capital was seen as any other good. A good that should be allocated according to the principles of a free market, if one wanted to maximise economic growth. The commission led by Per Kleppe took this logic fully on board. Taking a more national angle it also voiced its concern that Norwegian businesses would face higher capital costs than its competitors if they were not allowed free entry to the European market.

Remaining capital controls were lifted in accordance with the main SEM deadline for free movement of capital.¹⁹⁴ That day Norway had a truly free currency market. Ordinary Norwegian citizens could now speculate against (or for) NOK as much as their resources (and credit lines) allowed them to. Norway was not legally bound to do this. The EEA treaty was not yet signed at this point in time. Still, the issue qualifies as anticipatory action in the legal channel since it was pure import of the EC's directives for free movement of capital. This point will be further discussed in chapter 6 (subsection 6.2.3.3.1).

¹⁹³ In a Keynesian interpretation of the world these are really two sides of the same coin.

¹⁹⁴ 1/7 1990 was the formal deadline for eight of the EC's 12 member states. Most of them had liberalised their currency markets before the deadline. Greece, Ireland, Portugal and Spain however, had an extension for some regulations.

5.4 Twin crises: banking and currency

This section is about the two intertwined crises that hit the Norwegian economy at the turn of the decade. The economic crisis that started in general, and in banking in particular at the turn of the decade, and the currency crisis of the autumn of 1992 that culminated in December that year. These crises were intertwined in the sense that they that they influenced each other mutually. The uncompromising hard currency approach contributed to the depression that the Norwegian economy suffered at the beginning of the 1990s, which in turn co-caused the banking crisis. At the same time the steady flow of increasingly bad news about the state of the Norwegian banking system made it harder to defend the NOK. Bad news represented a drain on Norwegian credibility.¹⁹⁵ In the end, when the currency crisis finally came to a head, this also held the key to better times for the Norwegian economy in general and Norwegian banking in particular. The crisis ushered in an era of more flexible exchange rate management in Norway (and other countries) and more lax monetary policy in Europe. Both these shifts contributed to falling interest rates. Every single point made in this thesis is in some way or another related to the banking crisis. Subsection 5.4.1 therefore limits itself to a brief description of the depression and the crisis. The currency crisis will be described in subsection 5.4.2.

5.4.1 Banking crisis: heading for a fall

The economy does not react instantaneously to shifts in macro policy. In 1987 most economic indicators continued along trends established during the years of hyper-growth. Because of the oil price fall, BNP growth slowed down to just below two percent, but credit supply continued to expand fast from its already high level. The (household) savings rate was still hugely negative (around minus 5 percent) and

¹⁹⁵ In an effort to counter-act this effect Norwegian authorities spent a lot of energy informing international forums on how the crisis was handled. In October 1991 a joint memorandum from the Ministry of Finance and *Norges Bank* was handed out at an international bankers meeting in Frankfurt and later that month at an IMF meeting in Bangkok. At the first meeting governor Skånland also gave an oral presentation, while Minister Johnsen did likewise in Bangkok (*Økonomisk Revy* 11/99).

investment (outside the oil sector) was at about the same level as the year before. Inflation was also higher than the European average.¹⁹⁶

In 1988, however, the tables turned. BNP growth (including the oil sector) was negative for the first year since 1958 (Hanisch 1999:332). If we exclude the oil sector – which is probably more relevant for our purposes here – BNP growth was also negative in 1989 (Storvik 1997:58). Inflation fell below European levels and remained substantially lower than the European average throughout the crisis. Employment fell each year from 1988 to 1992 (Rødseth 1997:161). Unemployment nearly doubled in 1988 reaching almost 3.5 percent. In 1989 it passed 5 percent and by 1992 it was around 6 percent.¹⁹⁷ Property prices also started to fall. Business property prices fell by 50 percent from 1987 to 1991 (NOU 1992:30:33), while residential housing prices also fell dramatically, although not quite as steeply Steigum (1992:9,11) This set off a process of asset price deflation. Norway's indebted households responded to this by increasing savings, rapidly. The savings rate was positive again in 1988 and then it rushed up again peaking at almost 7 percent in 1993. Credit growth fell fast from 1988 to 1990 and through 1991 to 1993 it was negative. Until then this had been an unheard of phenomenon.¹⁹⁸ The domestic economy was more than sluggish. It was contracting, and with the contraction came a wave of bankruptcies. Highly leveraged business ventures catering for the domestic market (and often in sheltered sectors) created during the euphoric period proved particularly vulnerable. The bank's losses to these sectors also grew immensely during the crisis years.¹⁹⁹

¹⁹⁶ For credit growth figures see NOU 1989:1:table 4.1. For the savings rate see Isaachsen and Larsen (1998:107), while investment and BNP figures are from Hanisch (1999:332). Figures for BNP excluding the oil sector are from Storvik (1997:58, figure 1) and inflation data are from Rødseth (1997:161, figure 5.4)

¹⁹⁷ As measured by the OECD standardised unemployment rate (Moene, Nymoen and Wallerstein 1997:190: figure 6.1).

¹⁹⁸ As measured by *Norges Bank's* indicator "K1" which measures growth in the public's gross debts in NOK to Norwegian creditors. In 1990 *Norges Bank* introduced two more indicators "K2" and "K3" where "K2" measures the public's debt abroad (including debt in foreign currencies to Norwegian institutions). "K3" is simply the sum of "K1" and "K2". If we include "K2" in the numbers for the crisis years, the trend still looks roughly the same (Gulbrandsen 1995:96-97).

¹⁹⁹ NOU 1992:30:29.

In chapter four (section 4.3) we saw that the monitoring of, and predictions regarding, the business cycle in the 1984-92 period left a lot to be desired. This was true for the Ministry of Finance, the Central Bureau of Statistics and the Central Bank. First, the upswing was underreported and underestimated then the degree to which a highly indebted economy would cool off by itself was underestimated. The problem was, simply put, that there was no place for changed credit market behaviour in Norwegian macro economic planning. The process whereby asset price deflation and record high post tax interest rates stimulated increased saving and falling demand as individual families tried to get out of a situation where their loans outstripped the value of their housing investments was not really understood.²⁰⁰

Late 1987 and 1988 saw individual banks running into major troubles. The most spectacular case was when Norway's biggest bank, DnC, lost large sums after the international stock market crash of October 1987. Even though other banks also saw increasing losses this year, DnC's problems were largely ascribed to circumstances particular for this bank.²⁰¹ In 1989 the crisis was largely perceived to be over. The weakened DnC was being merged with Bergen Bank which appeared to be stronger. Kreditkassen – the bank about to suffer the worst losses of them all - was famously portrayed as “the winnerbank” on the cover of *Økonomisk Rapport*, one of Norway's business magazines (Meyer 1992:164).

This proved to be a false dawn, however. In 1990 it became clear that Norwegian authorities had a systemic crisis on their hands. All three of the biggest banks (four if one count DnC and Bergen Bank as two) needed help one way or the other. In the autumn of 1991 the crisis peaked and all the major banks more less fell into the arms of the state which ended up as sole owner of two of them (*Kreditkassen* and *Fokus Bank*) and majority owner of *DnB* (87.5 percent). Taken together,

²⁰⁰ Even without these oversights and faulty management tools, it could, arguably, still have been hard for “generals” that had just been allowed to start fighting one battle (against inflation and spendthrift attitudes among politicians and public alike), to readjust in less than two years.

²⁰¹ It also turned out that their star trader, a Frenchman brought in to bring international expertise to the bank, had exceeded his limits by using fraudulent methods. This in turn revealed that the bank's system for controlling risk, and indeed top management's understanding of short term trading in international capital markets in general, left a lot to be desired (Kjos Fonn 1998:103-116).

Norwegian bank's had operating losses of about 17 billion NOK in 1991 (Nilsen 1995:136). It has been estimated that Norwegian bank's received close to 25 billion NOK in various forms of support in the 1988 to 1993 period, with 1991 and 92 the two most "expensive" years. About 2/3 of the support came from the state and the rest from the banks' own guarantee funds (Nilsen 1995: table 8.2). The total support corresponded to about 3.7 percent of GDP in 1991. Gross accumulated losses 1987-1992 as they appeared in the banks' books were 70.6 billion NOK (Dokument 17:104). This corresponded to slightly more than 10 percent of GDP in 1991.²⁰²

5.4.2 Currency crisis: unsolicited relief

By mid-1990 it was thus clear that Norwegian banks were in deep trouble and that lower interest rates and a more expansive economic climate would have been most welcome. Such help, however, was not forthcoming. Instead the gradual reductions in tax-deductibility continued while the hard currency approach was pursued with great conviction and rigidity. Vicious cycles thinking had taken a strong hold, and it seemed that leading decision makers truly believed they had no other choice than to hold out and wait for better times.²⁰³ But, because of exceptional circumstances in Europe,

²⁰² The debate over the size of the losses and different estimates of "net losses" in particular is highly complex, and the statistical material available suffers because different banks have used different principles in their financial statements (Dokument 17:106). It is for instance not unambiguous how one should go about it if one wanted to net new actual loan losses in one year against loan loss provisions from previous years in order to arrive at a measure of net losses. While taking gross losses minus write-backs is even more complicated. Part of this last discussion is not even particularly interesting as it is extremely sensitive to the principles chosen for the calculation, in particular the time-frame applied. As the business cycle turned some bad loans "returned" to the bank's balances. This does not, however, alter the fact that some sort of accounting rules must always apply and that according to those that did apply in the early 1990s, the banks were insolvent at the time they were taken over by the state. See Dokument 17:89-123 for a very thorough discussion and analysis of this and other topics relating to the degree to which the banking crisis was influenced by the accounting standards applied at any given time. The general conclusion of the Commission behind the report is that the crisis was a real phenomenon. "The commission can find no basis for saying that accounting rules caused the crisis. Accounting rules did not cause the great number of defaulted loans and bankruptcies" (Dokument 17:13). The Ministry of Finance, on its part, has calculated that the net cost to the state was about 6.6 billion NOK in St.Meld. nr. 39 (1993/94:29).

²⁰³ The belief that one had to hold out can first and foremost be seen from explicit statements made during the hard currency period. This even holds for statements made after the NOK was forced off its peg (see for example *Dagens Næringsliv* 15/12 1992 and 4/2 og 9/2 1993). It can also be read off from the extreme measures actually used to defend the currency (see below). The debate on the banking crisis has also documented that several leading decision-makers of the day still insist that the

better times were not on the horizon. In July 1990 German reunification came into force. This inspired chancellor Kohl to push through two decisions that were to have a large impact on the economic policy of the republic. Firstly, he wanted reconstruction without tax increases. Secondly he made the politically important but economically nonsensical decision to exchange Ost-Marks for DM at a rate of 1:1. These policies lead to a boom, and then a permanent weakening of the fiscal position of the traditionally prudent German State. Above we saw that the interest rate differential between Germany and the USA was reversed from late 1989 on, because the American economy was going into a recession. From the autumn of 1991 the famously independent Bundesbank countered this twin threat to the value of the DM by embarking on a policy of tighter money. Thus it contributed to widening interest rate differentials against the dollar.²⁰⁴

In February 1992 the treaty of Maastricht, which entailed the introduction of a single European currency by 1999, was signed. This upped the ante in the game over Europe's exchange rates. Ideally, these were never again to be adjusted. Thus the EMS lost flexibility. At the same time, the popular reaction against the treaty of Maastricht, which resulted in dramatic referenda in Denmark and France, was eating away at the credibility of the EMU-project. Market actors were thus alerted that speculative attacks might yield good results. Meanwhile, the Bundesbank continued its policy of tight money, with German interest rates peaking in August 1992, (Sæthre 1995:367). This was ill suited to the state of the domestic economy for just about all the other ERM participants, since they were plagued by recessionary economies and high and rising unemployment. Other EMS-countries repeatedly asked the Germans to relax their monetary stance, but the Bundesbank refused to budge. Thus the scene was set for

uncompromising exchange rate stance was a wise policy (see chapter six for a discussion of this position). Sigbjørn Johnsen was minister of Finance in the most critical period, from November 1990 to October 1996. For his account of the currency crisis see Johnsen (1994:37-40).

²⁰⁴ In 1992 the average three month rate in the German money market reached 9.5 percent. In the USA the average rate on three month treasury bills was 3.4 percent. These two interest rates are not perfectly comparable, but they are the ones chosen by the IMF as indicators of short term interest rates in the press information released after concluding consultations with the two countries (IMF 1997a and IMF 1997b).

speculators, with greater degrees of freedom than ever before, to pile pressure on the European Monetary System.

The first country to give way was Finland. The Marka was released from its ecu-link on the 8th of September. Finland was suffering from the breakdown of their lucrative trade with the former Soviet Union, and was in a deep depression at the time. One week later Italy devalued within the ERM. This increased the pressure on Great Britain, who according to many observers had entered at a too high rate in 1990 (Stephens 1996:175). A few days after Italy's devaluation, the Pound was thrown out of the ERM by speculators.²⁰⁵ After British short term rates had been hiked to 12 percent in a last ditch attempt to save the Pound from "humiliation", the Treasury now allowed them to fall to around 7 percent (Tranøy 1994:186).

For Sweden the Finnish exit was particularly troublesome since the two countries compete in many price sensitive export industries. The state of the Swedish economy was also extremely poor in 1992, with a shrinking GDP, rapidly growing unemployment and a banking crisis of similar proportions to the Norwegian one (Tranøy 2000 forthcoming). In addition to these problems which Sweden shared with Norway, the country also had rapidly increasing current account and fiscal deficits. Swedish Central Bank governor Bengt Dennis tried extreme measures. He used enormous sums propping up the SEK and at one point the overnight interest rate was set at 500 percent. Swedish politicians followed up with two bi-partisan "crisis-packages", but to no avail (Dennis 1998, Stern and Sundelius 1998). In November Sweden gave up. After this the Norwegian government and *Norges Bank*, braced themselves for even tougher pressure (Johnsen 1994:38-39). Their fears were well founded and on the 10th of December the NOK was "provisionally" released from its

²⁰⁵ The British defeat on 16th of September 1992 - "Black Wednesday" – has later been attributed to the speculation of one hedge-fund manager, George Soros, who grew to world-wide fame after the episode. The well respected economist Paul Krugman, suggests that Soros's enormous, loan financed (one-way) bets and accompanying statements against the pound (which according to the nature of one-way bets tempted others to follow suit – see chapter six) may well have brought forward British exit from the ERM. At the same time he suggests that the British would most probably have left later that autumn anyway (Krugman 1999:122).

ecu-peg. *Norges Bank* stopped buying NOK, but even so it found a stable level between three and five percent below the peg (Alstadheim 1995:48).

In the summer of 1993 there was more trouble in the European currency market, and this time the problems went right to the core of the ERM. The upshot was new “provisional” fluctuation margins of +/- 15 percent, as opposed to the old margins of +/- 2.25 percent. Seemingly the ERM could hardly be called a fixed exchange rate system anymore.²⁰⁶ The more positive news for the ERM was that German interest rates started to come down, hence interest rates all over Europe followed suit. As we shall see in chapter seven, this was of great relief for Norwegian policy makers and most actors in the Norwegian economy.

5.5. Empirical epilogue

The presentation of the material needed for the analysis proper is now over. In this last section of the last empirical chapter I will bring the story of Norwegian macro-economic policy making up-to-date. But this empirical epilogue also has a counterpart, in what I have called an analytical epilogue. Based on the narrative given in the present section, I will try to evaluate how promising the emerging practices look in terms of co-ordinating functional interdependencies across issue areas.

Since this is an epilogue, and not a fully-fledged continuation of the descriptive analysis that has been undertaken so far, the exposition will be limited to macro-economic policy.²⁰⁷ The epilogue falls in three parts. The first deals with the immediate aftermath of the twin crises period, and the introduction of the “Solidarity alternative”, an attempt at establishing new more sustainable routines for Norwegian economic policy making. The second describes how the “Solidarity alternative” ran into trouble as the Norwegian economy was getting over the crisis and moving towards a high degree of resource utilisation. The third section covers 1999, the first of year of the tenure of the new governor of the Central Bank. This governor has instigated what has

²⁰⁶ The Netherlands and Germany made a bilateral agreement to stick with their old fluctuation margins.

been described as a monetary policy coup. He has moved it towards de-facto independence while assembling more power over economic policy making in the Central Bank than ever before in the post-war period.

5.5.1 The solidarity alternative

In the shadow of the chaotic and confusing situation Norwegian decision-makers suffered during the autumn and winter of 1992, a new national macro economic governance strategy was being worked out. A broad-based “Employment commission”, led by Per Kleppe, developed the so-called “Solidarity-alternative”,(NOU:1992:26). Kleppe, as we saw in subsection 5.3.1, also led the commission which had suggested ecu-linkage in the first place. The committee put forward several proposals. When it came to macro-economic governance it suggested a division of labour between the three key policy areas. Fiscal policy was to be used to control aggregate demand. Incomes policy should take care of improving competitiveness by aiming for wage inflation below that of Norway’s competitors. Finally the task of monetary policy should be to stabilise the NOK against European currencies to secure a stable monetary framework for incomes policy.²⁰⁸

In 1993 conditions were conducive to realising these ambitions. The, by Norwegian standards, record high unemployment rate indicated that fiscal policy should not be too tight.²⁰⁹ Historical evidence from both Norway and other countries suggests that it is easier to conduct counter-cyclical fiscal policy in a downturn than during an upswing. It is easier to distribute budgetary growth than cuts. The unemployment situation also dampened wage demands from organised Labour. The

²⁰⁷ I will return very briefly to other policy areas and market developments of the post 1992-era, in the analytical epilogue.

²⁰⁸ The macro-economic governance part, which I emphasise here, has probably become the most famous and is arguably the most important part of the legacy left by the two main reports produced by the “employment commission”. For the purposes of the present analysis this element is clearly the most important. It should be mentioned, however, that the commission had a much wider agenda. It put forward suggestions as to the composition of public expenditure, structural policy measures and it stressed the need for active labour market policy and “workfare”, that is a policy of requiring receivers of social policy “hand-outs” to actually work for their money (Dølvik et. al. 1997:93).

strife towards nominal wage moderation was further helped by the fact that real (disposable) incomes received a boost from falling nominal interest rates over the year. On the exchange rate front, Norwegian authorities spent the year or so after December 1992 waiting for the European regime to re-establish itself.²¹⁰ But if Europe failed to provide a regime to hook onto, the market was more helpful. NOK was basically left alone, even though it was formally enjoying a provisional float. In May 1994 what was evolving towards becoming a new exchange rate regime for NOK was formalised in the Government's new exchange-rate regulation:

"The monetary policy to be conducted by Norges Bank shall be aimed at maintaining a stable krone exchange rate against European currencies, ... In the event of significant changes in the exchange rate, monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range. No fluctuation margins are established, nor is there an appurtenant obligation on Norges Bank to intervene in the foreign exchange market."²¹¹

The way this regulation was interpreted from 1994 to the end of 1998 it translated into a different strategy to that which was pursued in the 1986-92 period, but it also had important similarities. The most important difference is that it was more flexible. With non-publicised margins of fluctuation and no obligation to intervene in the currency market, it became more difficult for market actors to make "one-way bets" or close to risk-free speculation against the NOK.²¹² The two strategies were similar in that interest rates were still bound up – even if not to the same extreme degree as before – in stabilising the exchange rate against European currencies. And the concept "European currencies" was - as before – taken to mean the ecu. To the degree that the Norwegian business cycle were to deviate strongly from the core EMS-countries' this would lead to pro-cyclical monetary policy. In turn this could undermine

²⁰⁹ As we have seen, in 1992 unemployment reached 6 percent. See subsection 5.4.1 above. .

²¹⁰ Hermod Skånland, lecture at *Norsk Utenrikspolitisk Institutt* 16.04.1999.

²¹¹ The mandate is laid down in the Exchange Rate Regulation, adopted when the revised national budget was processed in May 1994. Translation by *Norges Bank*, source: *Norges Bank's* submission on economic policy in 2000 (<http://www.norges-bank.no/english/publications/submission.html>).

²¹² Market actors can make a one-way bet against a fixed currency when it is under pressure to depreciate and the only two realistic outcomes are either a depreciation (which translates into profits for the speculators) or that it remains within its band. If the currency in question remains within its band the speculator incurs only transaction costs (interest rate differentials and exchange fees). The concept of one-way bets will be discussed in more detail in chapter six.

the incomes policy part of the “Solidarity alternative”. As we shall see below, this is exactly what happened.

In the spring of 1994, however, Norway’s business cycle seemed to be getting synchronised with that of mainland Europe. In *Norges Bank* the prevalent view was that Norway had finally fallen into step with its important trading partners on the continent. The current account was only showing a moderate surplus, and the petroleum sector was not expected to influence the business cycle to the same extreme degree it had done over the previous 10 years or more.²¹³ As it turned out however, the petroleum sector and thus the state’s revenues from it, grew much faster than expected by the technocracy in 1994.²¹⁴ Unemployment came down and the 1996 wage settlements were far more generous than the principles laid down in the “Solidarity alternative” suggested (Dølvik et. al. 1997:101).

5.5.2 Solidarity in trouble

According to the “Solidarity alternative” fiscal policy should have been tightened in this situation. Policy was indeed tightened somewhat in 1996, but in 1997 and 1998 as the economy was heating up fiscal policy was more or less neutral.²¹⁵ In fact Labour leader Torbjørn Jagland’s exasperation over what he considered to be a fiscally irresponsible opposition was part of his motivation setting an infamous ultimatum to the electorate.²¹⁶ For this line he received the full backing of LO-leader

²¹³ Hermod Skånland, lecture at *Norsk Utenrikspolitisk Institutt* 16.04.1999. See also the revised national budget for 1994 (St. meld. 2 (1993-94) pages 22 and 134 on this point.

²¹⁴ In 1994 the state’s revenue from the petroleum-sector amounted to approximately 8 percent of total revenue. By 1997 the corresponding share was approximately 18 percent (OED 1998).

²¹⁵ As measured by the structural budget balance in percent of GDP. For each of the years from 1994 to 1996 this indicator hovered between two and one and a half percent surplus. In 1997 and 1998 it was close to zero (Storvik 1998:68 figure 5).

²¹⁶ Jagland was frustrated over an electorate he felt took “the responsible governance of Labour for granted”, so that many who wanted a Labour-government still did not actually vote for it. Therefore he “demanded” a result at least as good as that obtained by Labour at the 1993 election (36.9 percent of the votes) for Labour to be willing to form a new government. Upon not getting this, he resigned. See *Aftenposten* 23.05. 1997 “Jagland: Farlige overbud”, and 10.08.1997 “Bare Jagland for Jagland”.

Hågensen, a man who more than any other individual has been identified with the “Solidarity alternative.”²¹⁷ The electorate did not respond sufficiently, thus Norway got a new centrist coalition government led by the Christian Democrat Kjell Magne Bondevik in the middle of the upturn. The making of the budgets for 1997 and 1998 were acrimonious with strong clashes between the Government’s of Jagland and Bondevik respectively, and Parliament. These budgetary processes demonstrated how difficult it can be to agree on cuts in public spending, especially so when there is no firm majority in Parliament. This is particularly the case for coalition governments since compromises have to be reached between parties with different “pet policies”.

Property prices which had been growing since the crisis culminated in 1993, climbed faster and faster in the last half of the 1990s. Private consumption increased and capacity utilisation as measured by the output gap increased rapidly between 1996 and 1998.²¹⁸ The “Solidarity alternative” was coming apart at the seams and the 1998 income settlement was extremely generous all round. Thus we can safely conclude that from the latter part of 1996 demand management considerations pointed towards increasing interest rates. In stead the Central Bank reduced its overnight lending rate with several small cuts from 6.75 percent in March 1996 to 5.25 percent in July 1997.²¹⁹ Thereafter interest rates remained below the level from early 96 until the summer of 1998, even though the economy was in danger of overheating according to the Central Bank. The reason that monetary policy was once again pro-cyclical during an upswing was that NOK was under pressure to appreciate. *Norges Bank*, felt obliged by the exchange rate regulation to try and keep NOK down through cutting interest rates and keeping a close eye on interest rate developments in the German money market.

²¹⁷ *Aftenposten* 01.07.1997 “- Regjeringen må gå med dagens oppslutning”

²¹⁸ The output gap measures the discrepancy between actual GDP and trend GDP, the idea being that this captures degree of resource utilisation. An output gap larger than zero indicates that the business cycle is in an expansionary phase, while an output gap below zero indicates a recession. In 1997 and 1998 the output gap was close to 3 and 4 percent respectively (see Skånland 1999: chart 2).

²¹⁹ Interest rate data in this subsection is, unless otherwise is specified, from Norges Bank: “Oversikt over virkemiddelbruk overfor finansinstitusjonene”, *Penger og kreditt*, 26 (4):590-591.

At the heart of this problem was - simply put - petroleum revenues. As we saw above, these grew phenomenally during 1996 and 1997 and this strengthened the position of the NOK vis-à-vis the core EMS currencies. The booming oil sector also contributed to increasing the output gap differential between Norway and Europe. The biggest economies in the EMS were sluggish during 1996, 1997 and 1998, and the output gap differential between Norway and “Euroland” (that is the 11 countries that were to join the EMU in 1999) went from zero in 1994-95 to around 5 percent in 1998.²²⁰ This gap illustrates well that Norway and the big economies of continental Europe had divergent monetary policy needs in this period. The Central Bank realised this, but felt hamstrung by the exchange rate regulation. The bank began to place more and more emphasis on the lack of synchronicity between the Norwegian and “Euroland’s” business cycle. It was realised that Norway’s departure from the path of the continental European economies was systematic and probably structurally determined.²²¹ Earlier the difference – to the degree that it was observed – was often thought of as a function of idiosyncrasies of Norwegian policy making (Skånland 1999:6).

In a submission on monetary policy to the Ministry of Finance sent in November 1996, the Central Bank complained discretely about the pro-cyclical effects of current monetary policy (Norges Bank 1996:B 283). In a submission written in October 1997 this criticism was repeated, but more forcefully so (Norges Bank 1997:558).²²² The Central Bank wanted greater flexibility. That is, the opportunity to take the state of the domestic economy more into consideration when setting interest rates, even if this meant letting the exchange rate diverge more and for longer periods from its target range. This proposal was flatly refused by the Bondevik government.²²³

²²⁰ Skånland (1999):chart 2.

²²¹ The Norwegian export sector with petroleum products totally dominant probably has a lot to do with this. On the other hand, over the 1990’s Norway’s movement over the business cycle has been better synchronised with economies such as that of the USA, the UK and Sweden (Norges Bank 1998:304)

²²² Norges Banks submissions for any given year are sent in October the year before. But in 1996 the bank wrote a special submission on monetary policy.

²²³ *Aftenposten* 07.11.1997: “Norges Bank fikk nei fra Bondevik”.

Given that *Norges Bank* has a strong tradition for moderate wording, the statement made by then Governor Kjell Storvik (1998:68) in his annual address at the meeting of the Supervisory Council in 1998, could be considered blunt:

It should be well known to this audience that our political authorities and Norges Bank have somewhat different opinions on the issue of how monetary policy should be conducted in the current situation.²²⁴

Later in 1998 the situation changed. Oil prices fell and this weakened the NOK. The oil price in turn, was part of a bigger picture. It had started with the so-called Asian crisis in 1997. By the summer of 1998 this increased in both scope and depth with turbulence in the world's currency and commodity markets. Currencies from economies dependent on the export of primary commodities (such as Australia, Canada, New Zealand and Norway) suffered more than other OECD currencies. This allowed Norges Bank to hike interest rates substantially. In the name of exchange rate stability short term rates were increased by 3.75 percentage points during two months that summer. This hike added urgency to negotiations over the budget for 1999.

Important preconditions behind the interest rate hike were clearly exogenous to Norwegian economic policy such as the oil price fall, global turmoil and depressed raw material prices. It is also debatable to what degree any given government can influence the wage-settlement in a year like 1998, when a tight labour market and pent-up pressures both contributed to the settlement. Even so leading opposition politicians such as Labour's Jagland and Petersen from the Conservatives chose to interpret the hike as a reflection of the sitting Governments lack of prowess in macro economic management. The sitting Minister of Finance, Gudmund Restad, had a torrid time in the press. His ordinary job was that of a local police officer, something which commentators were fond of pointing out at this point in time.²²⁵

After a messy process the centrist minority government lead by Bondevik decided to co-operate with the two parties to their right (the Conservatives and the Progress party) and a budget which was expected to tighten fiscal policy by around 1

²²⁴ My translation.

²²⁵ See Tranøy, "Mirkalman uten mandat" in *Dagbladet*, 28.12.99.

percent of GDP was adopted.²²⁶ Then it was loosened by ½ of a percent of GDP during negotiations over the revised national budget the following spring. Still, the process over the budget for 1999 illustrates that when Norway's external position is threatened, Cabinet and Parliament usually manage to tighten fiscal policy.

To this it should be added that the budget for 1999 was made according to a new procedure intended to strengthen Parliament's ability to focus on the budgetary balance. The principle behind the reform is that Parliament first vote on a number of expenditure and revenue frames (27 in all), as well as the sum total of these. Within these constraints committees are free to distribute resources on items. In the old system the total balance would not be targeted directly, it would emerge as the sum of a number of negotiations over smaller frames, and the actual balancing would be undertaken last. This reform was introduced in 1997, which means that it was applied to the budget for 1998. As we have seen, the budget for 1998 was not as restrictive as the economic situation demanded. It is therefore early to make general claims on the effects of this reform on total spending in relation to total government revenue.

The income settlement for 1999 was also very moderate, and during the spring of 1999 Norwegian interest rates started to come down again.

5.5.3 The triumphant technocrat

By this time however, the new Central Bank governor as of 1999, former top official from the Ministry of Finance Svein Gjedrem, had boldly decided to reinterpret the exchange rate regulation. Compared to his predecessor he shifted emphasis from the part of the instruction which talks about "maintaining a stable NOK exchange rate against European currencies" to the part which talks about orienting monetary policy "with a view to returning the exchange rate *over time* to its initial range (italics added).²²⁷ By deciding to take a more long-term view of events in the currency market,

²²⁶ I am referring to the structural budget balance. The numbers here are taken from Norges Banks inflation report (4/99: subsection 2.3) <http://www.norges-bank.no/english/inflationreport/1999-4en/index.html>.

²²⁷ The key phrases in their original Norwegian wording are as follows: *Norges Banks løpende utøvelse av pengepolitikken skal rettes inn mot stabilitet i kronens verdi målt mot europeiske valutaer, ... Ved vesentlige endringer i kursen skal virkemidlene innrettes med sikte på at valutakursen*

he in effect took a large step towards defining a (direct) inflation target rather than an (intermediate) exchange rate target for Norwegian monetary policy.

In his annual address at the meeting of the Supervisory Council of *Norges Bank* in February 1999, Gjedrem (1999:74) spelt out his new interpretation:

We must not allow ourselves to be blinded by daily exchange rate quotations. The experience of recent years shows that Norges Bank must take into account the fundamental conditions for exchange rate stability over time... Norges Bank cannot fine-tune exchange rate movements... It is up to Norges Bank to evaluate the best means of returning the krone to its initial range. This also means that the Bank must exercise a large degree of discretion when using the Bank's instruments, essentially the interest rate... There are two fundamental conditions necessary for achieving stability against European currencies. First, price and cost inflation must fall to the level aimed at by euro countries.²²⁸

These were not idle words. Gjedrem put – so to speak – the Central Bank's money where his mouth was. In January and February of 1999 the bank he leads twice sliced half a percentage point off interest rates before the NOK was back to its initial range against the Euro. In hindsight Gjedrem has explained this decision with reference to fear of bringing on a deflation.²²⁹ Tactically it could also be seen as an astute move. The first practical consequences of the new interpretation of the exchange rate regulation were popular ones. To argue against a strategy that implies a lowering of interest rates is never attractive to Norwegian politicians. It must have seemed particularly unwise at this point in time. The Central Bank's short term lending rate was at 10 percent, and most floating mortgage loans were around that level too. Until the cuts came, all leading Norwegian politicians had been complaining about – and distributing blame for – the high interest rates. In this light it is understandable that

etterhvert bringes tilbake til utgangsleiet. Det gjelder ikke svingningsmarginer med tilhørende plikt for Norges Bank til å intervenere i valutamarkedet. The most interesting contrast between the two wordings is that in the English version an equivalent for the word “løpende” (which means something similar to running or continuous) is missing. This might be considered a key word in the original text because in Gjedrem's interpretation the emphasis has been shifted from “løpende” to “etterhvert”, which means over time or eventually.

²²⁸ The page reference for this quotation is to the Norwegian version as printed in *Penger og kreditt*. The translation, however, is Norges Bank's own, taken from their web-pages.

²²⁹ *Den økonomiske politikken i 2000*, <http://www.norges-bank.no/publikasjoner/budsjettbrev.html>.

there was no immediate reaction from either the cabinet or parliament to Gjedrem's coup.²³⁰

Having secured tacit support for his new line, the new governor went on to show that his new policy cuts both ways. As the NOK regained its strength that spring, further interest rate cuts were expected but they came very slowly. By August 1999 the rate had only crept one more percentage point downwards and 6 out of 9 analysts interviewed by the news service *TDN* expected reduced rates after Norges Bank's board meeting that month. Their main argument was that the NOK seemed to be safely within its range, and Norwegian rates were still very high by European standards.²³¹ The bank, however, declined to do this. The governor defended this decision pointing to inflationary pressures in general and property prices in particular. During that autumn and the early winter of 1999-2000, the NOK spent a lot of time being stronger than the limit defined by the initial range. Still, the Central Bank refused to cut rates aggressively.²³² In stead Gjedrem has patiently been explaining that the economy has not cooled off fast enough and that he insists on a light handed approach when setting interest rates.

In general Gjedrem has spent a lot of energy communicating what he does and why he does it. His speeches and submissions are pedagogic, more clear-cut and most importantly more pro-active in expressing policy preferences than what was the case with his four immediate predecessors.²³³ On one press conference he presented 9

²³⁰ On a more personal level it could be argued that in his former position Gjedrem was key advisor to the present Minister of Finance. There is therefore a possibility that Restad is used to trusting – not to say depending on- Gjedrem's advice and that this has added to Gjedrem's authority in his new role.

²³¹ *Aftenposten* (internet edition) 22.08.99.

²³² After June 1999 he only cut the overnight lending rate once. This was in September 1999, by another half of a percentage point, bringing it down to 7.5 percent. By the time of writing final revisions (March 2000) the general understanding was that Interest rates were set for an increase again.

²³³ And this includes Hermod Skånland (1985-93), whose influence, particularly after 1986 was strong, but more discrete (famously understated and often ironic) in form. Gjedrem's other three immediate predecessors were Knut Getz Wold (1971-85) who was reduced by illness towards the end of his tenure. Torstein Moland (1994-1995), who was hampered by a tax dispute with the authorities which eventually led to his resignation. And finally, Kjell Storvik (1995-1998) in some ways an interim figure who was elevated from deputy governor when Moland resigned.

different scenarios for the economy and used this to specify what would constitute appropriate policy action for each possible outcome.²³⁴ This included specifying tasks for fiscal policy (i.e. for politicians) in situations where monetary policy would not be the most expedient instrument.

Gjedrem pursues this policy of “openness” for a reason. During the days of fixed or heavily managed exchange rates the Central Bank played *against* the market, and was quite often reluctant to show its hand.²³⁵ Large sums could be lost by the Central Bank (and gained by speculators) whenever market pressures produced unwanted exchange rate changes. Today inflation targeting seems to go hand in hand with a strategy of playing *up to* the market. Predictability and the ability to communicate seem to be more valued among central bankers today than before. Alan Greenspan, is chairman of the American central bank, The Federal Reserve. He is probably the worlds most respected central banker. In the late summer and early autumn of 1998 his stock rose even higher in the eyes of those who make their living in financial markets. He, personally, was given most of the credit for warding off what seemed to be an impending crash on Wall Street when several large hedge funds ran into trouble after Russia defaulted on her debt (Krugman 1999:133-134).²³⁶ In 1999 he established a practice of making it known in which direction the Federal Open Market Committee is “biased” after meetings where they have not changed the interest rate. In short, Greenspan performs his job of keeping the economy on an even keel by cutting a captain like figure, drafting the course for the markets and politicians alike.

²³⁴ The scenarios were generated by crossing different inflation paths with different levels for the exchange rate in a three by three matrix, see *Dagens Näringsliv* 17.11.99.

²³⁵ In the old days, Federal Reserve Chairman Alan Greenspan is said to have quipped “if what I said seemed unduly clear to you, there must be a misunderstanding somewhere”. The source of this story is unknown to me, and it doesn’t even matter whether its true or not, because it does characterise a mentality that was prevalent among central bankers around 10 years ago. This mentality held sway, also in the Federal Reserve, which for long periods have been known to care little about the external value of the dollar.

²³⁶ Among the steps taken by Greenspan was that he organised a rescue package for the most (in)famous hedge fund, Long Term Capital Management (which had two Nobel prize winners on its payroll), and produced two well timed interest rate cuts. But according to Krugman, “...even now Fed. officials are not quite sure how they pulled this rescue off...Indeed, some Fed. officials fret that

This is also the kind of central banker Gjedrem is shaping up to be. His own understanding of this aspect of his role was expressed in the submission on economic policy for year 2000.

Confidence is a fragile asset. It takes time to build up, but little to destroy...In this connection, Norges Bank emphasises transparency and communication of how monetary policy will be conducted.²³⁷

Judging from the running commentary made by various “chief” and “head” economists employed by the financial institutions, he is highly respected in the Norwegian market place. And, as we have already seen, his self-styled definition of his responsibilities have not been threatened by his formal task masters, the democratically elected politicians. To the contrary, in the Central Bank’s submission on economic policy for 2000, the whole executive board stands as signatories, including representatives appointed from within the ranks of the Labour party (2), the centrist cabinet (2) and the Progress party.²³⁸ The role of these political appointees is in itself interesting. As a group, they demanded to be more involved in interest rate policy in August 1998. This demand was put forward towards the end of a period when the bank’s rates, as we have seen, were hiked by 3.75 percentage points.²³⁹ Ostensibly this was a move that reduced the political independence of the bank. Given that Gjedrem has managed to get the entire executive board behind the new line however, it is tempting to argue that the board’s more direct involvement in key decisions has actually strengthened the hand of the governor vis-à-vis cabinet and parliament. By coming onboard, the political appointees have lent an air of democratic accountability to Gjedrem’s new course.

the public may be overrating their abilities – a new form of moral hazard, says one Greenspan adviser, based on the belief that the Fed chairman could bail the economy and the markets out of any crisis”.

²³⁷ An English version of this submission can be found at: [http://www.norges-bank.no/english/\(published/submissions\)](http://www.norges-bank.no/english/(published/submissions)). The quote appears on page 3 if the submission is printed in A4-format.

²³⁸ The executive board has 7 members. It is led by the governor, his vice-governor is vice chairman and the five other representatives are political appointees.

²³⁹ There was even talk of misgivings about governor Storvik’s handling of the “currency crisis”. His policy of using many incremental hikes was said by some commentators to be too indecisive. A maybe not altogether serious theory put forward in academic circles at the time was that Storvik tried to seem indecisive on purpose, in order to extract as large an interest rate increase as he could from the weakness of the NOK.

This might be important. Because Gjedrem's ambitions for Norway's economic policy regime is no less than to redefine the division of labour between policy areas as defined in the Solidarity alternative. What emerges from Gjedrem's analysis in the above mentioned submission on economic policy is a policy hierarchy, with the instrument he controls – monetary policy – on top. This, of course, is never stated, but if we scrutinise the argument made, it seems the most plausible interpretation. We have already seen that Gjedrem wanted to shift the emphasis of monetary policy away from short-term exchange rate stability towards price stability (and long term exchange rate stability). Gjedrem's analysis also implies changing the emphasis of incomes-policy away from inflation control over towards securing a high level of employment.

One feature of wage formation in Norway has been the considerable emphasis placed on cost competitiveness in wage negotiations...Norges Bank is of the view that the most important contribution to be made by such settlements is to ensure that structural unemployment in Norway remains low and employment high.²⁴⁰

We see that employment is to be secured through wage-moderation, i.e. low wage inflation, ostensibly the same task incomes-policy had under the solidarity alternative, and long before that. The new element appears only when one sees incomes policy in relation to the new role of monetary policy. Because giving *Norges Bank* freedom to set interest rates and making monetary policy ultimately responsible for inflation control implies that the bank can discipline the social partners if they enter into "irresponsible" wage settlements. In time merely the threat of such disciplining may well enter into wage negotiations as a factor in itself. In such a situation we can say that monetary policy is superior to incomes policy in the hierarchy.

Fiscal policy is relegated in similar fashion to incomes policy. The key premise here is that a high degree of resource utilisation – which Norway has had for a long time compared to almost all other European countries – reduces the efficacy of fiscal policy in demand management:

The allocation of resources between the sheltered sector and the internationally exposed business sector may be influenced through fiscal policy. Over time, the size of the exposed

²⁴⁰ <http://www.norges-bank.no/english/> (published/submissions). The quote appears on page 5 if the submission is printed in A4-format.

sector will be determined by a contest for economic resources between the public sector and the exposed business sector.²⁴¹

In short, this is an argument that advises caution in the use of fiscal policy. In a small open economy that already has a large public sector as it is, presenting the effect of fiscal expansion primarily as one of taking resources away from the “currency earning” sector, is a powerful rhetoric against demand management through the budget. And with a logic identical to the one that applies for incomes policy, the makers of fiscal policy are also vulnerable to punishment from a Central Bank that controls monetary policy for purposes of inflation management. If Parliament decides on a budget Norges Bank deems irresponsible, the result will be higher interest rates, and over time politicians will learn this.

²⁴¹ <http://www.norges-bank.no/english/> (published/submissions). The quote appears on page 5 if the submission is printed in A4-format.

Chapter 6: Analysis, theoretical interpretation, and local conclusions

The design of this thesis departs from the advice routinely given to doctoral students on at least two scores. Both departures stem from the question posed or how the “dependent variable” is conceptualised. By investigating co-ordination and its break-down and employing the label fiasco I have developed both a more explicit normative dimension, and a broader range of issues than those we normally find covered in empirical studies where the main task is explanatory. The issue of establishing a normative basis for an empirical study I will return to in the last of these two concluding chapters. The issue of complexity will be dealt with here.

Complexity follows from studying co-ordination. By definition policy co-ordination entails several issue areas, that are being more or less successfully adjusted to each other. Therefore, if one wants to study the break down of co-ordination one cannot at the same time limit one’s empirical scope in the name of parsimony and narrative tidiness. To compound matters, different policies are subject to different dynamics. Therefore in trying to account for the forces that pulled all these policies apart in the 1984-92 period, I have had to draw on a vast body of theoretical literature. In an effort to deal with all this complexity I have chosen to write two concluding chapters. This chapter concentrates on what I call local conclusions, while I address the more overarching issues in chapter seven. The local conclusions are arrived at by discussing the findings of chapters three, four and five in light of the theory on sources of co-ordination failure presented in chapter two.

I will also break another convention by bringing some new empirical elements into this exercise. Hence this chapter is not solely focused on theoretical interpretation of materials already presented in chapters three, four and five. New empirical material is added to the analysis. The motive is a desire to present an exposition that is as clear as possible. New elements being analysed are ones that would have broken up the

narrative of chapters three four and five. The justification for introducing these new elements at all, is that they can throw additional light on the theoretical interpretation undertaken here.

I proceed by discussing one type of disparate policy path at a time. Section 6.1 discusses asymmetrical degrees of stickiness, section 6.2 discusses selective learning while section 6.3 does the same for imported dynamics. Since I have chosen to divide theoretical interpretation and conclusions between two chapters, this chapter does not contain a separate summary. In stead I will seek to weave together the analytical threads that emerge from this discussion in a set of overarching theoretical conclusion in section 7.2 of the next chapter.

6.1 Asymmetrical degrees of stickiness

In chapter two, in subsection 2.3.1, I sought to theorise the dynamics of the phenomenon I have labelled asymmetrical degrees of stickiness. This discussion was summed up in six propositions. I will now confront these propositions with the five policy areas whose reform stories were narrated above. I do this to win deeper insights into how specific mechanisms associated with asymmetrical degrees of stickiness contributed to the unfortunate policy mix of the boom period. To be more concrete, two policy areas were liberalised before credit controls, and two were reformed after. This timing was unfortunate, since it contributed to asset price inflation and pro-cyclical monetary policy. But why were some policy areas smooth while others were sticky so that events unfolded in this sequence? This question will be addressed in the following five subsections, analysing one issue area at a time.

6.1.1 Concentrated benefits and diffuse costs: The share-market

The two policy areas that proved to be smooth in the sense that they were easily changed upon executive initiative were share and housing market regulation. In terms of the propositions the case of share market regulation is most straightforward.

Proposition number one was formulated thus:

Policies that give rise to diffuse costs and concentrated benefits have a greater chance of being supported by societal forces and less chance of being opposed and are therefore likely to make the journey through the policy cycle relatively fast.

We can also recall that proposition one can be supplemented by proposition three:

Policies that give rise to concentrated costs or concentrated benefits are more likely to have specialised organisations catering for these interests than policies that give rise to diffuse costs and benefits. The presence of such organisations can help delay/speed up the journey through the policy cycle of policies that run counter to/serve interests that are structured in a concentrated manner.

The owners of shares were the recipients of a “concentrated” benefit in the form of new tax incentives, lower transaction costs, and a more liquid market. At the same time both managers and owners of big enough businesses received a benefit in the shape of more options for external financing. The costs on the other hand - possible loss of government revenue and relative deprivation for those without the resources to enter the share market - were diffuse and difficult to attach to any organised or even identifiable groups. In chapter three we saw that organised industry interests first brought share market reforms on the agenda. This was picked up by political parties on the right, and was pushed through with no great difficulty in a reform process that even began before the Conservatives came into power.

On the basis of the admittedly relatively limited empirical evidence gathered on the share market reform process, we can therefore conclude that the expectation formulated in proposition number one is borne out in the data. Furthermore, the expectation formulated in proposition number three can supplement this conclusion. We can also note that the arguments mobilised for share market reforms had no relation to what is here identified as the key distributive effects of the reforms. On the other hand it is hardly surprising to note that the terms of the political discourse are thus that it is not considered effective rhetoric to argue for making the rich richer. In any case the key in the context of asymmetrical degrees of stickiness is as much to understand the absence of opposition as it is to identify support and arguments in favour of a given reform. On this note we can also register that integrated into the reform of the share market were provisions that made liberalisation more attractive and the market more accessible to broader strata. Namely substantial tax breaks on investments in mutual funds.

6.1.2 Concentrated benefits (and costs): reform in the housing market

Seen in “Wilsonian” terms, the case of co-operative housing is not as clear-cut as the case of share market liberalisation. This is so because although the winners (owners of co-operative flats) can be said to have made up a concentrated group, the same arguably went for the losers (first time buyers). Still reform was pushed through in the early years of Conservative rule. Labour initially opposed this. But as Bay’s study has shown, this was a costly strategy in terms of votes, and it was given up. In this situation objective economic interests on both sides of the conflict were concentrated, but reform was still easy to achieve. Thus more clearly than what was the case for share market reform, the case of housing demonstrates the need to move beyond a singular focus on interest structure. Not only must we consider the effects of specialised organisations (proposition three) but also that of tangibility and loss aversion (proposition six).

The presence and role of an interest mediating, specialised organisation cannot provide much of an answer to the present puzzle of why co-op reform was so easy to implement. This is because the main organisational actor – the “NBBL” – was at the horns of a dilemma in the case of price controls. The organisation had culture and tradition as a developer, instinctively arguing for the interests of new homemakers. On the other hand, as a function of growth over time, it accumulated members with often opposing interests and important among these, an interest in high secondary market prices.²⁴² This dilemma stopped the NBBL from coming out squarely in support of price control abolishment. Supporting the right for co-op estates to dissolve themselves was not even an issue, as it would have been destructive for the NBBL if this had gone through. A clear supporter of dissolution-rights did exist, but as we saw in subsection 3.3.3, this was an ad-hoc organisation of limited resources and it was linked only to the independent co-op sector. This organisation’s chief role was to provide ideas and

arguments that the Conservative Party picked up and turned into vote winning strategy. The key actor in the liberalisation process then, was not a specialised organisation, but the Conservative Party. Its strategy was to by-pass the major organisation of the co-op sector, and speak directly to the hearts and wallets of individual co-op members.

A fundamental question thus remains: Why was what in reality amounted to an inter-generational redistribution to, on average, older owners of co-operative flats from first timers more popular with the winners than it was unpopular with the losers? Why did the Conservatives gain from supporting the concentrated interest in reform, while Labour apparently experienced a net loss in votes in trying to cater for the interests of newcomers to the housing market?²⁴³

One possible explanation is, of course, that the first group was bigger than the second was. So much bigger that it was electorally significant. I do not have data that allow me to gauge the potential impact of group size, but it seems likely that by 1981 (the year of the election) the stock of co-op dwellers was bigger than the stock of households with ambitions of entering the price-regulated co-op market. It is, however, also worth reflecting upon whether factors such as tangibility and loss aversion can yield additional analytical leverage.

Building from the notion of tangibility can produce a plausible additional argument to help us understand the relative smoothness with which co-op reform was pushed through. The argument would be that seen from the standpoint of any co-op dwelling individual, your own home is perhaps your most tangible asset. More so than the expectation of an outsider of receiving one at a regulated price, which is what the situation of co-op dwellers must be compared to in this case. It is also likely that actually living on a co-op estate, participating in its organisational life, or at least

²⁴² The presence of such a dilemma was explicitly acknowledged (although in more general terms than I use here) by NBBL chief executive Sørgaard in a speech in 1982 (Annaniassen 1996:54-55).

²⁴³ Unlike the relationship between status in the housing market and voting behaviour presented in subsection 3.3.2, I do not have election data that isolate potential first timers in the housing market as a group. Thanks to Bay we thus “know” that Labour was punished by holders of co-op flats in the elections, while we can only infer that it is not likely that they were rewarded to any significant degree by first timers for their support of the status quo in the co-op sector. Their showing in the 1981 election was poor.

attending general assemblies and paying monthly instalments on your mortgages, facilitates developing a greater awareness of what was at stake in this issue area. One can hypothesise that it increases the flow of relevant information and that it provides incentives for taking the time to interpret the significance of how it impacts your interests. Through such a process a clearer sense of identity and the interest that goes with this identity can be developed. Regarding non-owners, there is a chance that several individuals who according to “objective” criteria belonged to the group of potential homemakers, had not developed a strong identity as such. Co-op dwellings could for many of them be considered as one of several options, and this group had no organisational focal point to help them develop a strong interest in price controls. In analytical terms we thus see that the organisational level reappears at this stage of the argument. Not as a political actor in it self, but as an arena for information exposure and interest formation. This line of thinking also highlights that there are limits to what one can achieve when one restricts one’s analysis to “objective concentrated” interests. If we accept the argument about information exposure and interest formation this entails that we move from a concept of objective interests to subjective interests. In the first case co-op dwellers and outsiders represent equally concentrated interests, while in the latter case we may well express the significant difference between the two groups as one of degrees of concentration.

The point of loss aversion is much trickier to argue. This is because it is difficult to establish what constitutes a loss and what constitutes a foregone gain. If I stay with the language I have used so far, linking the liberalisation of price controls to “windfall profits”, I am more or less led to define the situation as one in which the already established households stood to gain. This while newcomers was the group confronting a loss – a one-off hike in the price for entering the market. If this was the way things were perceived by the two groups of market actors at the time, prospect theory would actually predict more resistance from new-comers and less support for reform from the holders of co-op tenure. On the other hand one could argue that the opportunity to sell at market price came to be perceived so much as a right that not being able to do so constituted a loss for established co-op households. This while

newcomers to the market did not – as argued above – have such a clear sense of what they would be losing. But if we make this move we come so close to tautological reasoning that the whole exercise borders on the meaningless.

6.1.3 Technical complexity– experts time credit control repeal

The explanatory scheme of this part of the thesis links policy failure to unfortunate sequencing of change across different but functionally interdependent policy areas. The way I have organised the analysis makes it a key issue to explain why the time it took to implement different reform and liberalisation projects varied across policy areas – relative to the first round of liberalisation of credit controls and the explosive growth in credit supply that followed. If we accept 1 January 1984 as a watershed in the issue area of credit controls we see that this date is the measuring rod which gives meaning to concepts such as “sticky” or “smooth” which are applied to describe the processes of change undergone in the other policy areas. But how can we interpret the timing of the repeal of credit controls in terms of the theory presented in the previous chapter?

If we restrict the analysis to the 1984 measures, credit control timing was coincidental to the other changes being implemented around this time. As was discussed in a context of selective learning in chapter four, asset markets and credit liberalisation were never seen in context of each other. Credit market liberalisation was primarily viewed relative to the business cycle. This reflects expert influence in interplay with other factors. Firstly there existed – in my view – a formal decision to liberalise. Given this, strong expert influence allowed the implementation of the decision to be determined by considerations of how appropriate the timing was with regard to the business cycle. There is every reason to assume that democratically elected politicians were worried about rising unemployment. But as we saw in section 3.2, neither the party programmes nor the Finance Committee treatment of the measures in Parliament revealed any great interest in credit controls on the part of political parties or their

elected representatives. It was expert advice that pointed towards the credit market as the proper outlet for expansionary impulses.

Societal interest as represented by democratically elected politicians was therefore not attached to credit controls per se, but to the unemployment issue, and the linkage between the two in 1984 was circumstantial. As was argued in chapter two, the effects of a change in credit controls are so remote and difficult to compute for ordinary citizens that it seems perfectly plausible that this issue area simply does not possess ability to stimulate popular participation. But credit controls stretch the limits of our “Wilsonian” terms. (Revealed) popular interests were less than diffuse they were virtually non-existent. My argument is that this reflects the complexity involved. The flip side of this coin is, of course, a high degree of expert influence. To summarise our theory generated expectations to the policy area we therefore have combination of Krasner’s complex policy category and a functional equivalent to Wilson’s category of concentrated interest backing reform (technocrats) and diffuse (in reality no) interest opposing it (confer proposition number one). This should lead us to expect quick reform implementation driven through by technocrats. As regards the role of banks, one will recall from chapter two that I was unable to develop a clear prediction either way.

The historical evidence indicates that the real story went through different phases with pressure being exerted in different ways. As was reported in chapter three (section 3.2) the banks did, eventually, develop a stronger interest in credit control liberalisation. This came after expectations of this had been ignited by *Renteutvalget*’s report. But they were not allowed any direct influence through the democratic or corporatist channels. If banking influence was not achieved through political voice however, one can still hold that banks achieved it in a more indirect manner, through exit in the market. The evasive actions of banks in the market, ever more energetically seeking to circumvent the credit controls, strengthened the impression first in the Central Bank and gradually in the MOF that credit controls were not a very efficient way of controlling inflationary impulses from the credit market. Just how great emphasis the technocrats placed on the banks’ ability to avoid credit controls is

perhaps best illustrated by how the Central Bank interpreted credit market trends after liberalisation. As has been pointed out several times, credit overshooting in 1985 and 86 was largely interpreted as grey-market funds returning to the legitimate balances of the banks.

From chapter 4 (subsection 4.4), we also remember that the banks were kept outside the decision making process until all credit controls were lifted for good in 1987. What evolved instead was a complex game between eager technocrats and recalcitrant politicians. The technocrats wanted full-scale reform including the repeal of interest rate controls while the politicians worried about the electoral costs of higher interest rates. This also means that we need to reintroduce interest rate controls to the equation in order to understand the dynamics of credit control policy. As long as the technocrats of the Ministry were unable to extract higher interest rates from the politicians, they were willing to reintroduce a moderate version of credit controls in an (abortive) attempt to stem the growth of the credit market. As we saw in chapter 4 (section 4.3) even *Norges Bank*, which was highly critical to the extended use of primary reserve requirements, grudgingly accepted this for want of success in the interest rate issue.

The banks were simply sandwiched between the two groups with real power in credit policy, technocrats and democratically elected politicians. This rendered them unable to transform their concentrated interest in the full repeal of credit controls into political action. Democratically elected politicians held on to interest rate controls which in turn made the technocrats of the Ministry of Finance unwilling to abolish all credit controls, even though they supported this in principle. The peculiar dynamics of the politics of interest rate controls will be analysed in the next subsection.

6.1.4 From diffuse to concentrated opposition – tax rules and the credit market

In the description of tax policy in subsection 3.4.1, I argued that opposition against reducing the right to deduct interest payments from taxable income ran through

two different stages. In the first phase there was broad and general opposition. It seemed that all the parties, across the political spectrum, behaved as if they risked an electoral backlash if they tampered with the unlimited right to deduct interest from taxable income. In the second phase Labour managed to unify behind reform proposals, while the Conservative party more or less alone made sure that tax reform was further delayed. Together these two phases of opposition formed a sticky process that resulted in a late implementation outcome.

The two stages can be associated with two different dynamics of inertia, which in turn raise three questions. How do we interpret the two different opposition patterns respectively, and how do we interpret the transformation from the first to the second?

The second phase is a candidate for analysis along group interest lines. This is because it can be argued that tax breaks could potentially create a cleavage between high and low income groups. High-income groups faced higher marginal taxes, which meant that they shouldered less of their interest rate costs themselves, and as a group they responded to this by showing a greater propensity to borrow than low-income groups.²⁴⁴ And as could be read out of the illustration given in subsection 3.4.1, high marginal tax rates could make high-income borrowers all but insensitive to increases in nominal rates because they only carried a small fraction of the costs of such increases themselves. This also meant that even though a tax reform could be expected to contribute to lower nominal rates, the net effect would be an increase in the real post-tax rates paid by high-income earners. Finally, seen isolated, lower marginal tax rates would benefit (both low and) high-income groups. Nevertheless, given their adaptation to the old system through high indebtedness, it seems likely that the net effect of a reform would be negative for many high-income earners. In short, this is a complex matter where several contingencies should ideally be considered before one deduces interests. But if any cleavage is to be found, it should run between high and low-income groups.

²⁴⁴ A thorough empirical analysis of the distribution of net indebtedness across age and income categories and more can be found in NOU 1980:4: 91-116.

If we take the Labour party of around the middle 1980s as a proxy for the interests of low-income groups, and the Conservatives as a proxy for the interests of high-income groups, the outcomes we have seen – the Conservatives succeeding in pushing reform even further into the future – become intelligible. But how do we account for the earlier period, the period where Labour did not dare push for reform in a whole-hearted manner, and how do we account for their change of strategy mid-stream?

The puzzle of the first phase is that there are no visible signs of objective interests confronting each other on the political arena. Some groups arguably stood to gain from a reform. Even so, there was a conflict pattern that pitted a diffuse societal interest (civil society as such, so to speak) against a few governance minded elite politicians, no doubt seconded by technocrats concerned about the inefficiencies and perversions created by the old system. Still, the major role of the parties was to represent this generalised fear of reform into the (non-) decision making process.

The only proposition that fits with this kind of pattern is proposition number six.

Voters value maintaining established (and tangible and certain) politically distributed goods higher than the prospect of achieving new goods of a corresponding value, and party politicians can sense and act upon this. This is a mechanism that can produce delays in implementation, even in the absence of concentrated costs and specialised organisations.

The key words here are established, tangible, and certain. I would suggest interpreting popular scepticism against tax reform as stemming from fear of losing a tangible good. To be very concrete: Avoiding the loss of interest rate deductions was valued higher than the prospect of enjoying lower marginal taxes. This would be compatible with prospect theory's claim that people value avoiding a loss higher than the opportunity to achieve a corresponding gain. The tangibility of the good could further be said to be strengthened by the fact that interest rate deductions were tied up to people's investment in housing, and housing is no small matter to Norwegians. In the next subsection, when analysing the politics of interest rate controls this point will be elaborated upon.

The last element following from proposition six that should be considered is that of (un)certainty. One way of stating the key insight of prospect theory is that actors value avoiding losses more than reaping equivalent gains, given the same probability

of the two outcomes. The point here is that lack of trust in the political class can compound the effect of loss aversion. This can make losses seem more probable than the corresponding gains. The stated goal of the tax reform when it eventually came was to be revenue neutral. Revenue neutrality does not guarantee anything on the individual level of course, but it reflects an ambition of – on average - leaving the distributive bargain between the state and civil society untouched. Nevertheless, the recent experience of bracket creep and the seemingly ever increasing marginal tax rates this phenomenon brought about for large middle class groups, may have contributed to reduced trust in the political class in matters of tax policy. Households investing in housing had based their calculations on one set of rules. If these rules were to be changed mid-stream a majority of tax payers may have been distrustful of the political class' ability and/or willingness to do this in a manner which would not harm their interests (as tax payers) more than it benefited them.

Even if we accept that aversion against losing the tangible good of tax breaks and a general distrust of politicians conducting tax policy may partly explain perceptions of electoral costs across the political spectrum, this only solves half the puzzle. It still remains to be understood how this situation was transformed into one where Labour took a clear stance and the Conservatives came to represent a more concentrated opposition? This development probably has something to do with what arguments for reducing tax breaks on interest rates were most highlighted at different stages in the public debate. There were two main types of argument for tax reform in the Norwegian context. One set of arguments related to efficiency and the other to distributive justice. Efficiency arguments were many. Among them was the fact that unlimited deductions necessitated high net income marginal taxes and thus produced a dis-incentive to work, and an incentive to engage in “loan-financed luxury spending” as the rhetoric of the day would have it. Further it was argued that unlimited deductions made for problems of governability in the credit market while the accompanying high marginal rates stimulated creative forms of non-money remuneration, thus creating problems in tax collection. The distributive argument was simpler and should be well known to the reader by now: People with high income and

high marginal tax rates paid relatively much less of their interest rate expenses themselves.²⁴⁵ In interaction with other types of deductions the system produced a class of obviously rich people who nevertheless contributed nothing through income tax (*nullskatteyster*).

It thus seems reasonable to assume that arguing along distributional lines increased the likelihood of making the electorate see the issue of tax reform in terms of a cleavage between high and low income groups, producing a clear pattern of interest confrontation. Correspondingly, one can hypothesise that efficiency arguments were more likely to induce the kind of generalised fear of losing privileges in line with prospect theory and the argument about distrust in the political class. I have not conducted systematic research on this issue, but my impression from reading parliamentary debates and other documents is that Labour's spokesmen gradually got better at pinpointing the distributional consequences of the tax-system. In hindsight this seems an obvious choice: when trying to win support for a reform, point out that it is not fair. Particularly the concept of *nullskatteyster* – some of the best known of whom lived in obvious and media-covered affluence, can have served pedagogic purposes. A second factor working in the same direction is that individual members of the electorate could have come to better understand their stake in the issue: it being on the political agenda over a number of years from the late 1970s and onwards. Opinion poll data are consistent with the general proposition that the question of unlimited interest deduction gradually came to be seen as constituting a distributional issue between higher and lower income groups. In November 1977 more than 80 percent of those asked supported unlimited deductions. By November 1984 this share had fallen to 39 percent (Torgersen 1996:122: table 8.3.1).

²⁴⁵ Labour's members in the finance committee illustrated this point in their defence of a suggested reform in the following way. They pointed out that while families with an 1979-income of 70 000 kroner after tax and a loan at 10 percent in reality paid 6 percent "themselves" while a family with an after-tax income of 150 000 NOK paid 3.4 percent "themselves". (The effect of inflation is not considered in this example). Innst. S. nr. 320 (1979-80:17).

6.1.5 Diffuse opposition all the way – interest rate controls

In subsection 3.4.2 the main finding was that in this issue area the most important fault line ran between elected officials on the one hand and technocrats on the other, leading to a sticky process resulting in late implementation. All parties, no matter what class or social group they primarily catered to, were reluctant to take the lead in a process that could associate them with higher interest rates. Opposition was not concentrated: it was diffuse to the point of being all-encompassing. But it was also intense, thus demonstrating the limits of a pure “Wilsonian” approach. We are, in other words, confronted with a process similar to what I have called phase one of the controversy over tax reform, and an implementation outcome that resembles the outcome of the tax-reform effort. This similarity in outcome and process reflects that the two issues were partly shaped by similar forces. Reform attempts within both issue areas threatened to produce higher real interest rates. The link between the two issue areas will be a recurring theme below.

As in the analysis of tax-reform opposition, I will first try to account for the outcome in the interest rate issue by looking for an underlying structure of objective interests. This exercise can help us win a better understanding of the issue area. It can also demonstrate the limitations of this type of reasoning when applied to the politics of the credit market. By doing this I also strengthen the case for moving beyond these limits towards perceptions of interests, which is what I do towards the end of the subsection.

Seen from the objective interest perspective, the lack of a visible societal cleavage represents something of a puzzle, because interest rate reform (and even more so if we add reduced tax breaks to the package) can be seen in terms of opposing societal interests. Other things being equal, net creditors – i.e. mostly mature adults – would, clearly stand to gain from a reform that increased the real value of saving in the bank, relative to that of borrowing.²⁴⁶ Interest rates would go up if interest rate controls

²⁴⁶ This picture might be more blurred in an economy where non-professional financial investors hold a majority of their savings in mutual funds (low interest rates is considered to be good for stock prices). Norwegian saving habits have only recently begun to shift in this direction,

were lifted. While a tax reform would, and did, compound the effect of this for borrowers, the same would be true for savers. As marginal tax rates go down, the real return on money-savings go up. Why then, did not a single party find it worthwhile to try and represent the interests of net savers?

One possibility is that there were more net debtors than creditors in Norwegian society in the early eighties. Further we could assume that these were sufficiently evenly distributed across the political parties so that they formed a majority in every party. I do not have access to data that breaks down party votes on net financial positions of the electorate. Still, reasoning from crude gross figures indicates that it could be difficult to find empirical support for a hypothesis departing from the distribution of net financial positions on the political parties. As late as in 1985 for instance, Norwegian households were net creditors vis-à-vis the financial institutions (NOU 1989:1:197-198). And as we saw in chapter four (subsection 4.3) this was after the credit explosion had got well under way and the savings rate had fallen dramatically. Another indicator could be that as late as in 1980, lending from commercial banks amounted to 0.79 percent of their deposits, while the corresponding ratio for savings banks was even lower, 0.71 percent.²⁴⁷

Neither of these sets of figures conveys an impression of an electorate where a strong majority has an objective interest in maintaining low real interest rates in the private banking sector. If anything, households in general could have had an interest in increased real interest rates.²⁴⁸ The kind of argument I have made here, however,

however, and in the middle eighties people were still putting their money in the bank (Isaachsen and Larsen 1998). Also, the relationship between monetary policy and stock prices is context dependent. In situations where tighter money is deemed necessary in order to quell inflationary tendencies, it is likely that mainstream economists would argue that such a monetary stance would – other things equal - favour holders of all financial assets (with a possible short term exception of bond holders) because higher inflation makes for a less attractive business environment and it reduces real returns.

²⁴⁷ NOU 1992:30:102, table V.8. During the 1980's these ratios changed and grew larger than 1 - one - as credit market and saving behaviour changed and the banks started to draw more heavily on central bank and other types of non-deposit funding.

²⁴⁸ It should of course be considered that these bank lending-deposit ratios mix households and companies, and that they exclude state bank lending and claims on and debts to insurance companies. On the other hand these qualifications point in different directions as regards the financial position of the electorate and they would at least partially “net” each other out. Debts to state banks

should not be pushed too far. As stated above these are crude, gross figures. One obvious weakness is the risk of committing ecological fallacies. In theory, for example the impression that a majority of the households were in a financially sound position could have been created by a highly uneven distribution of financial wealth.

One conclusion I dare draw however. It is very difficult to formulate testable expectations of electoral preferences and their aggregation in parties in credit policy from rationalistic exercises over credit market economics. And this is not primarily because it is difficult to obtain specific and detailed enough data. The problems run deeper than what is in principle resolvable methodological concerns. My conclusion rests more on the observation that the political economy of interest rate controls is marked by a complex pattern of overlapping and criss-crossing cleavages, several of which have been touched upon in other parts of this analysis. This creates an indeterminacy that severely reduces the scope for deductive reasoning from an objective interests point of departure.²⁴⁹

One point that illustrates this is that the strength of “objective interests” in interest rate policy is highly sensitive to the kind of tax system one assumes that individuals use in their calculus. A second complication derives from the time frame employed: Households tend to move from being net debtors in young and middle-aged adulthood, to being net creditors in more mature years (NOU 1980:4:89). A third complicating question is how many assets markets to include in the calculus. In the short run bondholders gain from interest rate cuts, while households that hold their wealth in floating rate deposits loose. If we include expected price changes in the property market following from a change in interest rate policy, some group-interests might be reversed compared to what they would be without including this market.

would, if included, give us a picture where the net financial position of households would seem weaker than what we get from merely regarding the deposit-lending ratio of private banks. It would have the opposite effect to include the relationship between insurance companies and the public. Finally, the company sector was more indebted than households at this time, so not being able to subtract the effect of including companies contributes to deflating the surplus of the households vis-à-vis the banks.

²⁴⁹ This problem is inherent to pluralist or interest-based analysis. See Hall (1997:178) and Tranøy (1998).

Finally, interest rate changes influences the business cycle. For some this might be presented as a dilemma: Salaried net creditors can gain increasing returns on money-savings, but they also risk losing their job if a policy of sustained high interest rates brings the economy into a recession.

Thus we are back where we started, with the simple observation that electorates and the parties that woe them in general don't seem to like interest rate increases. With the crucial addition, however, that it seems to be impossible to account for this finding by way of deductive reasoning about objective interests. This highlights the need for attempting to understand the forces that shaped the perceptions of the electorate on the interest rate issue. The complexity of the individual calculus increases the relevance of looking for interpretative structures that help individuals orient themselves. In the theory chapter and in discussion of credit controls in subsection 6.1.3 above, I posited that technical complexity produced an ignorant public and that this in turn facilitated expert influence. When analysing interest rate controls the same link cannot be posited. There was a strong societal interest present. I will briefly run through three arguments about perceptions. Two are related to the broader political context in which the issue is framed when individuals interpret their interest, while the third is related to loss aversion.

One hypothesis could be that the frame individuals or households apply when evaluating events in the credit market is deeply influence by their identities in the housing market. This idea is inspired by Torgersen who encountered a similar pattern of broad societal opposition when studying popular reactions to various stages of the debate on Norwegian property taxes. He summed up his findings thus (Torgersen 1996:7)

Political conflict will not be between established and well known oppositions in civil society, battles will be fought against public authority. The state assumes the role of middle-man and takes the rap...Different types of diffuse opposition can unite groups whose real gain from different policy instruments can be very different and in some cases close to diametrically opposite.²⁵⁰

²⁵⁰ My translation.

Several aspects of housing policy and housing market trends in post-war Norway illustrate the importance of this issue area for credit policy. Torgersen (1996:70-88) mentions the following aspects among other things. By international standards Norway had and has a very high level of owner-occupancy. Co-operative ownership is also big. In functional terms this came to resemble owner-occupancy more and more. This was not the least the case in the issue of real interest rates. Both groups enjoyed full deductibility for interest payments. Housing consumption in Norway measured in square meters per tenant was very high by international comparisons. In opinion polls people in general expressed a strong preference for owner-occupancy. Finally, floating rate mortgages was absolutely dominant as the means of financing household's investments in property, which means that households were very sensitive to interest rate changes. One might also add that Norwegians in general have a strong preference for investing in second homes ("hytter"). This type of investment will typically be undertaken in middle age, after they have reduced the principal on the first home to a tolerable level.

The sum of all this would be that identity as investors in property is a fundamental part of Norwegian culture. For large sections of the electorate, the link between property investments and interest rate opposition can be reconstructed as rational. In these cases we are speaking of individuals who very likely and in the foreseeable future would see their net disposable income reduced by the abolishment of interest rate controls, or reduced tax breaks or both. The real puzzle is – as pointed out by Torgersen in the case of housing tax as well – the historical record indicates an extremely broad opposition. If we assume that the choices of the political parties effectively reflected the preferences of the electorate, opposition must have been so broad as to encompass groups who stood to gain as well as those who stood to lose from reforms. What this boils down to is a claim that the culture of property ownership tilted preferences so that being able to borrow money relatively cheaply was valued more highly than the ability to get a better return on money savings. It is hard to pinpoint the micro-foundations of such an argument. Still, that is not a compelling reason to leave it alone. The picture that takes shape if one considers the struggles over

tax deductions, property tax, and interest rate controls together, indicates that Torgersen might be on to something, when he speaks of opposite interests being united in a struggle against the state.

A second aspect of interest perceptions that could help us understand opposition to interest rate hikes is loss aversion. This point was discussed more extensively in the above subsection on opposition against reduced tax breaks. Therefore I will only repeat the essential point. Prospect theory is compatible with an empirical pattern of visible opposition and what appears to be an invisible or at least very weak support for reform. Prospect theory predicts that those who stand to lose from a reform are willing to risk more fighting against it, than those who stand to gain from the same reform are willing to do in fighting for it. We see that this line of argument forces us to abandon the notion of close to all-encompassing opposition. In stead it basically says that people who stood to gain from reform did not engage, leaving the field alone to those who stood to lose. If this was the behavioural pattern underlying the politics of the issue, this could of course convey an impression of all-encompassing opposition.

A third hypothesis about perceptions could be that voters care more about the state of the economy as such than about how it impacts them according to their position on any given societal cleavage line. This kind of idea is captured in a concept known from British discourses on politics, and is referred to as the “feel good factor”. A similar idea underlies important contributions to a more formal branch of political economy, namely the literature on political business cycles.²⁵¹ Here the main proposition is that politicians in seeking re-election, stimulate the economy so that it peaks around election-time. Sometimes this kind of proposition is made in order to explain the course of the economy. Others have turned the tables so that economic performance is used to account for (retrospective) voting. In later versions partisanship and divergent unemployment/inflation trade-offs between left and right wing parties have also been introduced to these models.

²⁵¹ The following paragraph on “political business cycles” is largely based on Peter Hall’s review in Hall 1998:178-180).

What we can lift from this literature is the general assumption that voters react to the state of the economy as such – or to be more precise – the level of effective demand in the economy. The argument is compatible with my finding. In its original version the political business cycle argument goes directly from individual voters to the electorate as a collective. Intermediary organisations or other kind of group interests were not invoked. If we apply this logic to the case at hand, the argument would be that low interest rates stimulate investment which spills over into a general kind of optimism. The corollary to this would be that being associated with higher interest rates and reduced investments entails electoral dangers.

6.2 Selective Learning

In chapter two I discussed biases that we could expect to be active in an economist-dominated technocratic learning process, like the one that informed the making of Norwegian credit market liberalisation. I distinguished between biases that we can associate with technocratic learning process in general and those that spring more directly from the characteristics of economic knowledge production. In chapter four I presented four stories about oversights in policy-making. Two were about precautionary policy and a systematic and close to all-pervasive underestimation of risk. The other two were concerned with serious deficiencies in how the boom period was read off, interpreted and therefore, in how it was sought counter-acted.

In the following it is my aim to discuss what we can learn from these stories in light of these taxonomies of biases. First I will consider the relevance of the biases that can be associated with technocratic learning processes in general - problem-centred allocation of critical attention and the need to “sell” a message. Then I will discuss the biases that are rooted in economist methodology - obfuscation of learning, focus on rationality and disregard for history. This discussion is divided in two parts. The first part focuses on the macro-discourse. It demonstrates that the technocrats preparing and implementing reform did not pick up available economic knowledge about credit market volatility. The other looks at the micro-economic discourse of the technocratic

community. Here it is shown that reasoning within a crude deductive-axiomatic neo-liberal framework entailed ignoring important differences in risk exposure and risk handling between the social democratic and the liberal credit market regimes. Finally I will briefly analyse how conflicts between local, institution-specific rationalities impeded the ability of the polity as a whole to deal with problems that emerged during the liberalisation process.

6.2.1 General biases – problem orientation or salesmanship?

In chapter two I formulated the expectation that learning would be partial in as much as critical analysis would only be applied to those routines where there was a significant gap between results and goals. Furthermore, drawing on Kuhn, I suggested that new axioms of credit market analysis would be protected from critical examination. These behavioural principles also indicate that we can expect a bias against seeing functional interdependencies that have so far had benign effects. Selective learning of this kind entails that there is danger of ending up with an inadequate mix of new and old policy routines. The empirical material in chapter four by and large strengthened these expectations.

The most important general conclusion I can draw on the basis of the stories told in the empirical sections above is that *critical attention* is a very scarce resource indeed, and the little there is of it is reserved for what is experienced as pressing problems. In military lingo there is a term called “clear and present danger” and it is tempting to invoke this as a metaphor for how critical attention was allocated in the technocratic learning process. This pattern of attention allocation had the interesting consequence that it led to a kind of systematic optimism on the part of the technocracy. It was as if they thought they could get something for nothing. They focused on the problems they had had, but they did not see the problems they could end up with in stead or even in addition to their old problems. This principle characterises various parts of the technocratic discourse on liberalisation. It could also, however, be seen playing itself out in the way the banks formulated their strategies and generally handled themselves in the new, more permissive environment. At both levels the

increased levels of risk that were associated with the new governance and marketing principles respectively were underestimated.

A narrow focus on recently experienced problems entails that its not only the policy implications of the new theory (neo-liberalism) – or in the case of banking the implications of a new marketing centred strategy - that escaped critical attention. It also meant that functional interdependencies that had hitherto had benign effects were ignored. If an old routine could not be linked to any experienced problems, there was a tendency to stay true to this routine. So, even in the middle of implementing radical change, inertia is present and important. As we have seen in chapter four, several old routines both in policy and banking proved inadequate in the new context. To keep up policy traditions like ignoring changes in the level of indebtedness, or to take a relaxed view on capital adequacy, proved very unfortunate in a context where both consumers and banks developed new behavioural patterns. Likewise, for banks to uphold old practices such as an informal attitude to risk and portfolio management was not advisable given their new aggressive strategies.

But can my material also tell us something about how a possible consideration for the need to “sell” the message through presenting a united front influenced the input of the technocrats to the liberalisation process? On this score my interpretation is negative. I find no indication that the technocracy on purpose concealed serious doubts about the liberalisation project. My reading of the relevant policy documents and my interviews with the main actors offer no evidence of such a motivation. I believe that what we are confronted with here are what we may call genuine oversights. One indicator of this is that the oversights made were pervasive. They extended also to issues where the technocracy could have taken a stance that reflected a deeper appreciation of the functional requirements of liberalisation without compromising the idea of liberalisation as such. The Ministry of Finance could, for example, have supported a quicker build up of loan-loss reserves or they could have placed greater emphasis on the quick acceleration of indebtedness in the economy when advising on macro policy without endangering the consensus that liberalisation was a good thing.

A second indicator that the oversights made were genuine rather than strategic is that I have found only one occasion where the consensus on the merits of liberalisation was threatened from within the technocracy. Except for the one attempt made by *Bankinspeksjonen* in 1983 that was mentioned in subsection 4.2.2, there were simply no critical voices to suppress. And when this analysis was ridiculed or at best ignored, this probably reflected genuine disregard. It was not a case of keeping a lid on insights one knew to be true and which were therefore deemed dangerous. This has to do with how power and respect was distributed between the Ministry and the supervisory body. Colleagues in the Ministry did not hold the economists of *Bankinspeksjonen* in the greatest regard.²⁵² That the supervisory body was worried was not in itself a good reason for the Ministry to be worried. Secondly the supervisory body dared suggest official sanctioning of cartel-like business practices. This they did at a time when both leading academics and the Conservative government was busy singing the praises of competition. Thus, even though this case illustrates disagreement among the technocrats, the balance of power between the two institutions involved was so uneven that the episode hardly represented a strategic threat. It was rather a reflexive act of belief conservation on the part of a massive majority than a strategic move.

Having concluded that there was a general bias towards pressing and experienced problems in all the case materials, it is time to turn to the role of biases particular to economic knowledge production. The key point is that economic research in the service of policy, and the work conducted by *Renteutvalget* is the chief but not the only example here, is motivated by a desire to elucidate the consequences of political choice. We can say that it represents an attempt to overcome the bias towards present problems that by necessity dominate day-to-day decision making. As we have seen the knowledge base built up by the technocracy before and during liberalisation did not quite live up to this ideal. This is where biases located in the nature of

²⁵² Interviews with Erik Lind Iversen, Per Melsom both 04.03 and Svein Aasmundstad, 05/03 1998. Lind Iversen is at the time of writing still working in the supervisory body, Melsom and Aasmundstad are former leaders.

economic knowledge production can enter the analysis. To help us get a better understanding of why this failure to grasp important consequences of political choices occurred, in spite of ideals to the contrary. As a way of synthesising the empirical discussion in chapter four, we can distinguish between two technocratic discourses regarding liberalisation. First I will analyse the discourse centred on stabilisation policy and macro governance. Thereafter I will look at the more micro-oriented discourse that centred on the allocation of credit and growth.

6.2.2 Economic knowledge production – the macro discourse

What in retrospect is most striking about the discourse on stabilisation as it was expressed in the reports of *Renteutvalget* (NOU 1980:4) and *Mål og Virkemiddelutvalget* (NOU 1983:29) is that the idea that liberalisation could create complications for stabilisation policy never appears. It is my contention that this reflects a bias against history. The implicit timeframe employed was restricted to the post-war era. In turn this meant that the experience of the inter-war period was not considered when liberalisation was planned.

This is all the more interesting since the main technocratic motive for wanting liberalisation was the belief that liberalisation would improve stabilisation policy. Chapter three (subsection 3.1.1) included a short description of the pre-liberalisation learning process. This was done in order to emphasise the crucial role of the technocracy in bringing the decision to liberalise about. In this section I take the political influence of the technocracy as a given. This allows us to move on to the quality of the advice provided. When the aim is to understand the purposes of understanding selective learning new aspects of the learning process need be emphasised. Firstly, the belief that liberalisation was good for stabilisation followed from how the credit market was conceptualised. The key notion was that there is such a thing as an equilibrium price for credit. A price that balances supply and demand in a stable equilibrium. Furthermore the move towards equilibrium was thought of as close to a natural force. This meant that a system of regulation that sought to keep a lid on interest rates and credit supply simultaneously was bound to fail. The market actors

would make contracts outside of the regulated market anyway. And even if – despite of this – one should have been able to control the supply of credit through controlling the liquidity of the banks, this would still be insufficient in terms of inflation management. This was because the demand for liquid assets could vary independently of the supply of credit. Consequently the only way to control inflationary impulses through monetary policy was to go for the more crude measures – the supply of money, and to do this one had to utilise the price mechanism.

Thus we see that belief in fine-tuning in the optimistic 1960's sense was dented, while within the stabilisation discourse maximisation of employment had lost ground to minimisation of inflation as the overriding goal of policy. If we take into account what was not said, however, we see that an implicit belief in macro-economic management had survived although this is easier to define negatively. Violent, policy-assisted and credit-led swings in the business cycle were no longer perceived to be a potential problem. Even though tools once held as crucial for this fight against the vagaries of the business cycle had been given up, the technocratic conviction that man now controlled the business cycle remained. Again we see that critical attention is narrowly applied, aspects of the Oslo-school heritage that could not be linked to pressing problems, were not reflected upon and thus carried along.

This restricted historic horizon in turn reflects the general disregard for economic history that characterised economic knowledge production in Norway at this time. The analytical comparison between a market free to find its equilibrium price and a regulated market, can be seen as a theoretical superstructure imposed on the lesson from 25 years of experience that regulation leads to leakage. Leakage led to inflation, and after the experience with stagflation in the 1970s, inflation was feared. But fear of inflation was restricted to wage and consumer price inflation. In general neo-liberal thought around 1980 tended to assume that markets are self-correcting. Subsequently it speaks of “corrections” rather than “crashes”. The default advice is to leave markets to their own devices and asset price inflation was not included in the arguments. The mode of reasoning was too partial, the danger of interaction effects between different markets was not heeded. To understand why asset price inflation is dangerous to

stabilisation policy one would have had to engage the kind of historically informed disequilibrium economics referred to in section 4.1 above. But this literature had – as we saw – fallen off the mainstream agenda.²⁵³

There are at least three arguments that make it more understandable why this bias against historically informed economics was not challenged in the technocratic learning process that led up to credit market liberalisation. Firstly, and my evidence from interviewing top officials from both the Central Bank and the MOF on the one hand and from the banking sector on the other is unequivocal on this point. The many years of smooth growth and insignificant credit losses made a crash landing inconceivable. This held both for the economy as such and for the banking sector in particular. Secondly, as was discussed in the historical preamble to chapter three, Norwegian economics had as a part of the heritage of the “Oslo-school” little time for financial and monetary matters, neither in teaching nor in research. Thirdly, for historical reasons and partly as a result of political choices, Norway had until the mid-eighties, comparably underdeveloped financial and assets markets.

If we move from the big historical picture and underestimation of systemic risk at the planning stage, to the governance challenges that actual stabilisation policy raised during liberalisation, this can serve to underline the significance of the bias against taking learning effects into account. In section 4.3 I described how the technocracy interpreted the credit expansion that followed liberalisation as illusory. Expansion was not real, it was a case of “Old funds” returning from the grey markets to the “legitimate” balances of banks and other institutions. Credit was compared to water, “it would find its own way” was the favoured metaphor. Hence we see that the cognitive framework of neo-liberalism directed attention exclusively towards one particular mechanism behind the overshooting of 1984-86. A supplementary and numerically more important mechanism, that the public’s demand for credit could in fact - in the short term at least – be impacted by easier access to credit was overlooked.

²⁵³ It may also reflect statistical conventions. Often consumer price inflation is measured at the retail level. Asset price inflation on the other hand is then left to appear as a good thing, as increased wealth for holders of the assets in question.

In fact the public's propensity to borrow increased dramatically in all the four biggest Nordic countries – when the rules of the game were changed from state enforced restrictions on the supply of credit to a liberal order (Eika and Nymoene 1992). In turn this behavioural change was reflected in asset price inflation and consumption boom. This gave the technocracy another chance to reflect on the relationship between liberalisation and credit market behaviour, but these data were not adequately reacted to in Norway (or in Sweden or Finland for that matter).²⁵⁴ But, as we have seen, levels of indebtedness was not a part of Norwegian economic modelling. In turn this clouded the technocracy's ability to see the significance of the relationship between this variable and the business cycle. This had not been felt as a pressing problem as long as the indebtedness variable "behaved" like a parameter. And when it stopped doing that, it took a long time before this was understood.

To juxtapose the interpretation of credit overshooting with the disregard for indebtedness levels allows us to further illustrate the key point in this discussion of selective learning. This is that the failure to comprehend the seriousness of the situation was due to a combination of letting the emerging cognitive framework off easily and not questioning hitherto well functioning routines rooted in the old framework. While it was the cognitive framework of neo-liberalism that predisposed towards interpreting credit overshooting as illusory, old routines based on Oslo-school thinking, sustained the technocracy's ignorance of the importance of changes in indebtedness levels throughout both the up- and the downturn.

6.2.3 Economic knowledge production – the micro discourse

In previous work I have discussed how the discourse on effects for resource allocation in *Renteutvalget's* report in general was based entirely on axiomatic-deductive reasoning.²⁵⁵ As regards the issues of risk taking, risk management and

²⁵⁴ For Sweden see for example Tranøy (2000 forthcoming). For Finland see Anderson et.al 1993:34-41).

²⁵⁵ The committee even overlooked well known research done in the Central Bureau of Statistic in the 1960s which indicated that Norway had an impressive rate of investment but that the rate of return was low. This research could have been used to support their analysis with respect to the

precautionary policy, this mode of reasoning produced a remarkably sterile analysis. It reads almost like a daydream. A free market consisting of atomised actors that are given the possibility of optimising their mix of investment and consumption over time by a credit market, producing pareto-optimal outcomes in all sectors and in all time-periods. The word risk only appears in the context of discussing the role of capital markets and banking in the economy – as opposed to an economy with no market for risk distribution and no intermediaries. The points made are that capital markets and banks help disentangle economic risk from economic entrepreneurship, so that risk can be carried by those most able and willing do so. Furthermore it is argued that a liberal credit and capital market creates a more efficient market for risk, one in which risk is priced “correctly”. This increases the possibilities for diversification of risk in a way that reduces the total amount of risk assumed in the economy (NOU 1980:4:65, and appendix II *ibid*).

We see that with the kind of rationality assumptions utilised in the analysis, there is no question of risk-taking getting out of hand. Risk is just a factor uniformly calculated by actors and distributed according to their preferences (i.e. the distribution of risk aversion) and ability to pay. A functioning price mechanism linked to clear probability calculations means that there is a perfect symmetry between the risk you assume and the rewards you reap if the “gamble” pays off so to speak. Learning is not so much obfuscated as it is ignored all together, as actors adapt instantaneously to a new incentive structure. The point is made that abolishing credit and interest rate controls takes away a disincentive to assume risk on the part of banks. But this is considered a good thing, since “a bias towards low risk projects is not necessarily good for the economy as a whole” (NOU 1980:4). It follows from the argument above that in a liberal order those willing to assume risk would be allowed to do so, while they could still bring their total risk-exposure down through diversification strategies.

Since the link between liberalisation, credit growth and increased credit risk is not pursued any further in the report, the analysis does not lead up to the subject of

efficiency losses they argued would result from a highly regulated market for credit (Tranøy 1994b:447-448).

precautionary policy. In fact this subject is given no mention, even though the report with appendixes is more than 300, closely written, pages long. The implicit assumption seems to be that liberalisation places no functional demands on precautionary policy or indeed on its corollary at the level of individual banks – routines for risk management. In general, organisation, decision-making and strategy at the level of individual banks is not considered a variable in the analysis. Strong assumptions of unitary rational actors capable of instantaneous adaptation get in the way of imagining the level of inter-organisational inconsistency, fumbling, and downright inadequacy that came to characterise many of the banks' actions during the boom period. Issues such as bank craftsmanship and how this was embedded in a culture that also organised social relations between banks and their environments was even further removed from the thrust of the analysis.²⁵⁶

This last point is worth more reflection. I will proceed by comparing the bank-customer understanding that underpins the concept of relationship banking to the kind of understanding of the same relationship *Renteutvalget's* analysis led to. I do this because I consider it the most telling illustration of how inadequate the technocratic discourse in the year 1980 was in terms of preparing decision makers in the bureaucracy, in politics and in banking for the challenges that lay ahead.²⁵⁷

In section 4.1 I introduced the concept of relationship banking. This can be understood as a system for reducing problems of asymmetrical information and trust,

²⁵⁶ When the present author gave a lunch-talk to the staff at *Norges Bank*, 6/2 1995, former Governor Hermod Skånland made a remark that in hindsight he could see that neither he nor the other macro-economists in the bank did have nearly enough knowledge of bank-internal processes during this period. The gist of his remark was that the habit of viewing banks as rational unitary actors that could be manipulated in simple stimulus-respons games was an impediment for insight in what was actually going on.

²⁵⁷ The committee behind the report had a lot of experienced based and academic expertise within its ranks as well as academic expertise at their disposal to produce background papers. Top technocrats from the Ministry of Finance, the Central Bank and Statistics Norway, were joined by the leaders of the two banking organisations (one of whom was a former top bureaucrat and a future CEO of Kreditkassen) to make up more than 50 percent of the committee. The remaining places were mainly filled up with representatives of the political parties.

problems which are difficult to get a handle on when markets are viewed as consisting of atomised actors. This point can be summed up thus:

Stability in the bank-customer relationship increases the quality of decision making. Over time the bank builds up knowledge about the customer which makes it easier for the bank to gauge whether the customer has the will and the ability to honour its contract with the bank.

In *Renteutvalgets* world banks had no problems with obtaining accurate information or with (breach of) trust. This leads the committee to conclude that established customer relationships or a good savings record should not be used as criteria when banks make their credit decisions (NOU 1980:4:68).

This could mean that identical projects are treated as if they differed in the credit allocation process. Credit decisions will come to depend on a random factor such as who owns the project. This will obviously clash with the conditions that have to obtain if resources are to be put to use efficiently...Established relationships and savings record should in reality be uninteresting from the point of view of resource allocation.²⁵⁸

But the notion of relationship banking is about more than information and trust. It also draws attention to the possibility that banks have to influence their environment through co-operation. After the initial contract has been made the “actors-as-atoms-model” sees bad loans as exogenous to the bank. That is, a state of affairs that “happens to it” if the contract for some reason is no longer respected. Relationship banking focuses on knowledge about the customer. The assumption is that such knowledge entails several advantages. It makes it easier for banks to contribute to developing the business of their customers and it improves chances of seeing problems early and to extend help in order to rescue a credit from turning bad. This can cover everything from developing custom made financial packages for “ordinary” customers, to the development of new repayment schedules and bringing in managerial support to customers in trouble.

So far in this subsection I have discussed the micro-discourse as it was represented in a report that had contributors from all the major institutional actors except the supervisory body. I have tried to emphasis a common factor: leading technocrats across different institutions were equally unprepared, intellectually, for the challenge liberalisation brought to precautionary policy. The main thrust of the

²⁵⁸ My translation.

empirical stories on precautionary policy and macro management during the boom underscores this impression. The degree to which liberalisation increased risk was systematically underestimated across all the major arms of government as it was by the banks themselves and their associations. Still, if we move from the general discourse and towards the institution specific agendas and identities of the individual institutions, interesting and - on the face of things - confusing, contrasts appear. The next subsection analyses this issue.

6.2.4 Local rationalities and institutional conflict

In the discussion on micro-foundations in chapter two a point was made that pertains to institutional conflict. The point was that partial but valuable insights embedded in the local rationalities of the individual institutions run the risk of being lost rather than aggregated and carried over into policy if institutions clash over how to interpret and handle given situations. This mechanism is illustrated by the pattern of disagreement between the technocracies of the Ministry of Finance and the supervisory body on the issue of loan-loss reserves. Disagreement over capital adequacy show a similar if inverse pattern between these two actors, while it also involved other actors. The picture is even more chaotic if we look at the pattern of support and opposition that characterised the conflict surrounding the issue of primary supplementary reserve requirements in the attempts that were made to cool down the credit market in 1985 and 1986. The outcome of all three processes, however, did share one quality: they were as we saw in chapter four, highly inadequate compared to the governance challenges they involved.

In the confrontations over loan-loss reserves and capital adequacy neither the Ministry nor the supervisory body displayed a consistent approach to the risk that followed liberalisation. Seen in the context of precautionary policy, the two institutions' positions here form a confusing pattern. This indicates that other considerations embedded in institution-specific rationalities were more pressing. In 1983 the supervisory body tried to voice a concern about the relationship between increased competition and risk. As we have seen, the Ministry was not impressed either

with the work of the supervisory body or seemingly with the credit risk agenda as such. The document was ridiculed before it was allowed to sink without a trace. On the other hand we have seen that there are strong indications that the bureaucracy of the Ministry was critical of the decisions made in 1984 and 1987 which eased access to subordinated loan capital. At these points the banks were in successive rounds allowed to dilute their capital standards through increasingly lax rules regarding the use of subordinate loan capital.

The supervisory body, seemingly unable to link their general analysis of 1983 with the issue of subordinated loan capital as it appeared on the agenda in 1984 and 1986/7, supported both rounds of relaxation. In the case of loan-loss reserves there was again a role reversal. Here the supervisory body on three different occasions took what might appear as the more risk averse stance as it fought for lifting the ceiling that applied to loan-loss reserve provisions. In this case, however, the Ministry was not worried enough by capital adequacy concerns to support the plea. In a risk management perspective the two government bodies clearly took inconsistent positions in the two single most salient issues of precautionary policy.

My interpretation of this pattern is that it reflects that neither the MOF nor the Supervisory body linked liberalisation to risk in their internal discourses. This facilitated a relative negligence of risk-issues on the part of both institutions. Furthermore, this negligence allowed them to pursue agendas specific to their own agendas and identities. The factor common to the positions taken by the supervisory body is that they reflected an identification with the interests of banks. It concluded its ignored warning of 1983 by supporting a return to cartel pricing. Higher limits to loan-loss provisions would reduce the tax bill of the banks and the banks needed subordinate loan capital in order to finance their growth. *Bankinspeksjonen* had a long tradition for identifying with the banks. The practice of conducting on-site inspections – which was a frequent practice until the early 1980s – helped develop bonds between the industry and the supervisory body. The employees of *Bankinspeksjonen*, felt that they understood what was going on in the banks better than other bureaucrats could. A

quiet word, patience and a discretionary approach was better than strict rules and strict enforcement.²⁵⁹

It is also easier to make sense of the positions taken by the Ministry if we accept as a premise that risk was an issue of secondary importance. Basically the Ministry had its focus on other aspects of the issues in question. To encourage cartel pricing was – as stated above – a non-starter. Making such a suggestion probably served to reduce whatever respect the supervisory body commanded in the Ministry. As regards the loan-loss issue, the MOF did not provide elaborate justifications for its refusal to allow increased provision at the time of the requests. In interviews with the latest commission on the banking crisis, however, its then two top officials have stated that they primarily had fiscal concerns. Loan-loss provisions were tax-exempt and the Ministry considered existing rules as quite favourable as they stood. Furthermore it was a general aim of the Ministry to reduce the number of breaks in the Norwegian tax code in order to reduce what was considered too high marginal taxes on both personal and corporate income (Dokument 17:80-81). For the MOF loan-loss reserves were part of tax discourse, further hampering the development of separate discourse on capital adequacy. In contrast to this, a more restrictive stance on subordinate loan capital would not be opposed to other interests the Ministry had. To the contrary, the MOF might even have seen that stricter rules on this score could help control the boom, although I have never seen sources indicating that this – in hindsight – obvious point was being made. What I have indications of, however, is that on this issue the technocrats of the Ministry were not in control. The decision was probably the result of a lobbying campaign targeted at the Ministry's political leadership. And at this point the technocrats of the Ministry received no support from either the Central Bank or the supervisory body.

²⁵⁹ In addition to being based on my interpretation of the actions of *Bankinspeksjonen*, this impression of attitudes in the institution is based on a general interpretation of my interviews there. I also have a direct statement made in my interview with Per Melsom (04.03.1998) who has the longest living memory of life there. He worked for Bankinspeksjonen from 1960 to 1970. Then he spent 10 years working on banking matters in the MOF before he returned as chief officer in 1980. In 1986 he stepped down, but he continued serving the supervisory body for several more years.

The importance of institution specific agendas and rationalities is even better illustrated by the debacle on primary and supplementary reserve requirements during 1985 and 1986. In chapter four (subsection 4.4) we saw that at the height of the credit explosion four milieus that had an ability to influence regulation and through that banking behaviour, had a conflicting understanding of what was going on, what was important and what could be done. The Ministry of Finance was partly aware that the credit market was getting out of control, and wanted to fight this with measures that reduced the profitability associated with growth. The calculus of a typical fast-growth bank was incomprehensible to economists with a minimum of faith in rational action. As a result the Ministry was unable to take on board to what degree the banks were now willing to tolerate low margins in exchange for keeping market shares. The banks own interest organisation, the NBA saw that primary reserve requirements did not have the desired effect and in a desperate move actually requested that other, but tighter, regulations be used. Relations between the two organisations were strained, however, and as we saw the NBA got close to the worst possible outcome seen from their perspective.²⁶⁰ Democratically elected politicians, that is government and parliament were, for their part, primarily concerned with keeping interest rates down and minimising the political costs flowing from increasing rates at the retail level.

Finally, *Norges Bank* had its aim fixed at what to its leadership must have seemed like the bigger picture: They wanted liberalisation and a more market conform model of monetary policy. In order to achieve this they were willing to accept not only one step at a time which in itself opened up for inconsistent policy mixes. They were also willing to argue for positions they were against. Such as asking banks to keeping a lid on interest rates and implement policies it was opposed to, like lowering money market rates. All this the Central Bank was willing to do if it was deemed necessary to avoid a political backlash against the liberalisation measures that had already been implemented. In a similar strategic perspective one could also ask if Central Bank economists and other proponents of reform in fact calculated that if parts of the reform

²⁶⁰ Interview with Trond Reinertsen, 27/05 1992

programme could be rescued, other parts would have to follow. For instance that credit overshooting would press home the message on interest rate and tax policy reform, so that it could actually be helpful in breaking the political deadlock. If that was the case, they were right in the long run, but it also entailed taking on enormous costs in the medium term. Bigger costs than they would have accepted if they knew exactly what they were doing:

There was however one thing that three of the milieus (and part of the fourth) could agree upon through 1984 and 1985: It was more important to show restraint in fiscal than in monetary policy. Indirectly, this tells us something about how the explosive credit growth was perceived in leading circles while it was in the take-off phase. Einar Lie (1998:81) who has had access to internal memos from the MOF to the rest of the Cabinet for these years, finds a clear tendency to prioritise fiscal policy. In early 1985, for example, the MOF said that fiscal policy in 1986 should be tightened to make room for a more expansive monetary policy. For *Norges Bank* criticism of fiscal policy is close to a ritual, and that the NBA, which represents the sectoral interests of banks in this picture, should agree with this view is perhaps not surprising. But that the real centre for economic policy making, the institution that controlled the main levers of policy, should want to make room for a more lax monetary policy after a year of record-breaking expansion is significant. It illustrates how poorly credit market developments and the risks they entailed, were understood at that time.

6.3 Imported Dynamics

Even more than what is the case for the two other sources of disparate policy paths discussed above, the concept of imported dynamics refers to an eclectic mix of theoretical ideas and inductively based insights. The common thread, however, is that these ideas and insights suggest ways of getting closer to understanding how and to what degree external events influenced Norwegian policy making from 1986 and onwards, the period I chose to study in chapter five. The following subsections organise the material in a way that seeks to strike a balance between chronological and analytical considerations. First I discuss the “turning operation” of 1986 in light of a

“Katzensteinian” approach to elite-compromises and learning from Europe. Second I move on to how Europeanisation to an increasing degree dominated economic policy-making in the 1986 to 1992 period. The three channels that Europeanisation works through, the legal channel, the ideas channel and the market channel are treated in different subsections.

6.3.1 The Oil price shock, europeanisation and the timing of compromise

In chapter two I discussed Katzenstein’s notion of policy making based on elite compromises, and some of the critique this work has provoked. Katzenstein’s own emphasis is on flexible adaptation. In his view the closely knit elite networks that characterise small, open Northern European political economies are able to hammer out compromises that secure effective adaptation without threatening social cohesion. We also saw that some of his critics think that this is too rosy a picture. These critics would claim that consensual policy making can produce rigidities as different groups fight to minimise their share of the cost of transformation, in other words a macro perspective on the politics of sticky policies. Thus, I presented two versions of the Katzenstein story, the original optimistic version, and the secondary, pessimistic interpretation.

Furthermore, I argued that there is good reason to expect that politicians are more reluctant to support radical reforms than technocrats are. This means that the threshold a typical politician has to pass before he supports reforms that are unpopular with large or concentrated and well-organised groups is likely to be higher than that of an economic policy making specialist. The empirical material presented in chapter six can be interpreted as showing that the oil price fall helped Norwegian politicians pass such a threshold. Monetary policy was radically reoriented so that interest rates were allowed to rise, and tax reform was achieved (in steps), contributing even more to higher real post tax rates. Both of these decisions were consensual. Except from the Progress Party’s opposition to the nature of tax reform (but this party was founded on a demand for slashing taxes) all major parties were behind these choices. The decision to go for an uncompromising fixed exchange rate was driven forward by the Central

Bank and a Labour Party which had just returned to power, it was more or less passively accepted by other parties. Tax reform on its side was, as was clear from Synnes' account, hammered out in Parliament, in an atmosphere of national crisis and urgency.

In short, the conclusion I draw from studying the turning operation of 1986/87 is that it can be conceptualised as a breaking point within the process of transformation studied here. The main conclusion to be drawn is that the oil price fall was decisive for the timing of the turn to austerity because it was interpreted as a performance crisis. The challenge from Europe underscored the gravity of the situation. The Norwegian economy was losing ground just as Europe started to pick up speed. This facilitated learning. Oil incomes and the buffer they provided had been taken for granted. The drastic price fall revealed that tough choices had to be made. The logic of the game changed from the one described in the pessimistic version of the Katzenstein story to the one depicted in the optimistic version. In this crisis the real strength of the corporatist culture and institutional set up as a system for producing tough decisions was demonstrated.

If the oil price fall cleared the way for reform, europeanisation helped single out in which way reform should go. How the choice of a rigid exchange rate regime was influenced by other countries' experiences has already been detailed in chapter 5. And I will return to this in the subsection below that is specifically devoted to learning. Here I will instead focus on rigidity. Because the decisions to implement tax reform and reorient monetary policy, however impressive they may be as acts of consensual policy making, did not represent the end to all problems in economic policy making. To the contrary, both decisions introduced a rigidity to policy making that became more and more problematic. As the downturn caught pace and a downward spiral of falling GDP, increasing unemployment, bankruptcies and loss making banks developed, the chance to shift real post tax rates downward would have been most welcome.

This was not done however. Partly, as we saw in chapter four, for reasons of ignorance: For long the severity of the downturn was underestimated. But there were

also more informed motives behind the rigid stance. Tax policy had proved extremely hard to reform, and when consensus was finally achieved it was not very attractive to stop the yearly progression on the road to less generous deductibility rules. Exchange rate policy was rigid for a different reason. The whole point was to build up credibility vis-à-vis international markets and other countries. This could not be achieved if one left one's commitment the moment the going got a bit rough. How long it was necessary or wise to hold out, is another issue, which will be discussed in chapter seven. This dilemma makes it tempting to reflect upon the dual status of rigidity. When it signals commitment it is viewed as a positive thing. When it reflects group interests it is viewed negatively, as a barrier to constructive action. But this distinction is not unambiguous. Rigidity as commitment can also create serious problems, delaying overdue change. We can also note that as far as exchange rate policy goes, europeanisation eventually solved the problem it created when Norway was thrown of the ecu-peg. This will be dealt with in subsection 6.3.2.3.

6.3.2 Europeanisation and policy content

In chapter two it was argued that an important way in which imported dynamics shapes national co-ordination capacity is through influencing the content of chosen policies. It was suggested that we can differentiate between three ways in which the content of economic policy can be influenced thereby impacting co-ordination. These channels are the legal channel, the ideas channel and the market channels

6.3.2.1 Capital controls, europeanisation and the legal channel

The process described in section 5.3.2, whereby the remainder of Norwegian capital controls were lifted, can be categorised as having taken place through the legal channel. Above we saw that harmonisation with the EC and its internal market was on the Norwegian governments' agenda from 1986. This effort was seriously stepped up as the EEA process got under way. Relatively uncontroversial issues were pushed through, often without any political debate. Without such a strategy the Norwegian political system would never have been able to push through so comprehensive

changes within the kind of time limits the EEA-process involved (Sverdrup and Farsund 1994). The remaining capital controls were such a case.

That the issue was relatively uncontroversial – the central bank wanted it, business seemed to have a general interest in it and nobody else engaged themselves – probably means that capital controls would have been lifted sooner or later anyway. It is also part of this picture that the OECD was working on similar reforms at this time. Still, experience tells us that even reforms that there is a large degree of substantial agreement on, can take time to implement. Also, an apparent consensus can dissolve when interested parties realise that what seems to be a technical matter is actually more than that.²⁶¹ On this background it seems plausible to claim that the EEA process explains the timing and specific content of this important reform.

6.3.2.2 Exchange rate policy, europeanisation and learning.

In this subsection I will argue that Norwegian policy makers learnt from the success of the EMS, and that Europe in this way “supplied” ideas that were picked up by decision makers looking for a new strategy in 1986 and for an adjustment of this strategy in 1990. Viewed from the perspective of vicious cycles theory, the lesson was that a fixed exchange rate was achievable also for states with a past as a devaluing economy, and that this represented a viable path to lower inflation. In addition, the increasing stability of the EMS provided a more stable context for Norwegian efforts towards the same goal. That Norway could interpret its own choice in light of experience gained and theory developed in the EMS countries was explicitly stated on some occasions. In 1987, the Central bank governor gave a lecture to the yearly

²⁶¹ In the summer of 1991 I worked as a journalist for Norwegian Radio. In this capacity I interviewed Norway’s then Minister of Finance, Sigbjørn Johnsen about exchange rate management and the high interest rates that this demanded. After the formal part of the interview was over I asked what he thought about the so-called “Tobin-tax, that is a marginal tax on short term capital movements designed to raise the threshold for speculative capital movements. He said that he had never heard about it, that his advisors had never brought this up and to him this indicated that it could not be a very important issue. Since then, however, long after liberalisation was complete, the issue of capital controls in general and the Tobin tax in particular has been raised by democratically elected politicians who have caught on to some of the troubles currency speculation can lead to. This was done In 1993 by representatives of the Centre Party and Socialist Left party, and in 1998 by Labour’s leader Torbjørn Jagland.

convention of Norwegian economists that explained the new economic strategy. At several points in this speech he referred to the fact that the smaller EMS countries followed a strategy of backing a fixed exchange rate with interest rates, and that Norway was now following suit because "we did not have any other choice" (Skånland 1987:138). In a large report on the state of the Norwegian economy delivered to the Government in 1988, the choice of irrevocably fixing the exchange rate was argued for in terms compatible with vicious cycles theory (NOU:1988:21). The argument was repeated and refined in *Norges Bank's* response to the report.²⁶²

More generally we know that technocrats meet in forums like BIS, IMF and OECD, and their many expert committees. It seems implausible that Norwegian thinking about the problems that follows from frequent devaluations should have emerged in a national intellectual vacuum. In addition to being influenced through professional channels, we also know that politicians meet and exchange reflections. The French experience under Mitterrand made a deep impression on social democrats all over Europe (McNamara 1998:139). Gro Harlem Brundtland, the Norwegian Prime Minister ultimately responsible for the choice of an uncompromising fixed exchange rate strategy, has on several occasions pointed to the Mitterrand experience. Her interpretation is, unsurprisingly enough, that it demonstrates the futility of one country reflation alone in an internationalised economic environment.²⁶³ Finally, a more general argument in favour of the thesis that countries learn from each other in exchange rate policy can be ascertained from research on large data sets. This research has demonstrated that choice of exchange rate regimes tend to follow a cascade-like pattern, where trends change fast across large groups of countries (Gates and Moses 1996).

The 1990-decision to switch from a trade weighted basket to ecu was heavily influenced by developments in Europe. Reading between the lines in the report of "Kleppe-utvalget", my interpretation is that the committee was quite impressed with

²⁶² *Norges Bank's* letter to the Ministry of Finance, 4 November 1988, quoted in Moses (1995:351).

²⁶³ See for example Brundtland's ARENA-lecture 1995 (Brundtland 1995).

the performance of the EMS at this time (NOU 1989:1:25, 50, 55-56). The EMS certainly seemed to go from strength to strength in the late 1980s. There were no major realignments between 1987 and 1992 and inflation rates were converging.²⁶⁴ The prevalent understanding of this was that it was possible to import West German inflation performance by way of exchange rate policies.

The EEA-process added impetus and so did emerging plans for the EMU. Most important of all for the ecu-decision was, however, the idea based on vicious cycles logic that a more credible external link would yield lower interest rates. The 1986 consensus on a fixed exchanged rate was not at all broken by 1990. But it was being strained by the fact that the reward for monetary rigidity was delayed compared to expectations politicians must have had in 1986. Therefore the link (however incorrect it proved to be) between ecu-fixing and lower interest rates must have made Europe seem very attractive, so attractive that even the Centre Party, the most anti-EC party in Norway, was willing to give the ecu-link a try.

6.3.2.3 The market – channelling other people’s problems

From as far back in history as 1984-85 when an enormous growth in funding from abroad helped fuel the lending boom, via the devaluation of 1986 and up until today, the market channel has had important impacts on the ability to co-ordinate policy. The single most important episode in my judgement however, was the currency turmoil that began for earnest in 1991, and which peaked first in the autumn of 1992 and then again when the ERM more or less collapsed in the summer of 1993. Up until December 1992 this was part of the problem. Turmoil led to upward pressure on Norwegian interest rates at a time when the economy clearly needed lower rates. Then the market brought relief through forcing exchange rate co-operation back to less ambitious levels.

The European currency turmoil originated in processes that had nothing to do with Norway’s economy. In theory, Norway’s vulnerability should have been much lower than that of other countries that were hit. Sweden and Finland each had severe

²⁶⁴ Italy devalued in 1990, but this was after the committee handed over its report, and Italy had a reputation as something of a special case anyway.

troubles on their current accounts and in fiscal policy. In no small part thanks to petroleum revenues, Norway had no such problems. Great Britain, on its part, had entered the ERM with an overvalued pound (Stephens 1996:175). Other factors that destabilised the ERM were the British reservation against the EMU, and finely balanced referenda on the Treaty of Maastricht in Denmark and France.

Still, changes in the structure of the currency market made it possible for market actors to mediate between these developments and Norwegian exchange rate policy. Successive rounds of liberalisation had created a potential for speculation of mind-boggling proportions. The EEA-motivated liberalisation undertaken in 1990 provided all private investors and non-financial companies with access to credit or own funds the right to speculate against the NOK. On top of the speculation conducted by financial institutions and foreign investors this made for an enormous pressure on the exchange rate. This can be illustrated: in the space of 24 hours in November 1992 *Norges Bank* spent 50 billion NOK worth of currency reserves (Johnsen 1994:39).

According to the criteria most commonly used by central bankers and market operators the Norwegian economy was in a reasonably sound condition in 1992. The banking crisis could produce a few jitters, but the Government never gave investors reason to fear for their money. As we have seen, all debts – including subordinated loan capital was – were honoured with the help of the state. And compared to most other European countries, Norway's economy looked strong. Public finances were strong, the current account showed a healthy surplus and inflation was decreasing year by year. Why, then, was Norway not able to avoid being caught up in the turmoil?

One link works through the Nordic level so to speak. As Finland and Sweden came under increasing pressure and eventually gave up, this on its own increased the pressure on Norwegian authorities to give up the exchange rate. Price-sensitive Norwegian export industries of some economic and even greater political importance are in direct competition with businesses in Finland and Sweden. Pulp and paper are the most obvious cases in point. And if the political demands of these industries were not on their own decisive for the decision to liberate the NOK from its ecu link, it most certainly helped fire the expectations of the currency market. I will return to the

importance of expectations below, as part of a longer discussion of the structural framework within which exchange rate policy was conducted by the early 1990s.

The first factor that should be considered here is the incentive structure created by a rigid fixed exchange rate policy. Seen from the point of view of speculators, this presented an opportunity to enter into one-way bets against the Central Bank. Another phrase that springs to mind is risk free speculation. The key premise is that a central bank can either manage to defend the exchange rate or the currency drops in value. Appreciation is not a realistic outcome in the short term. This means that Norwegian economic actors, could exchange some of their financial wealth into Deutsche Mark, in the expectation that they could buy back NOK later, at a lower rate. The worst case scenario for such speculators was that the Central Bank should succeed in defending the exchange rate, which would mean that they could buy their NOK back at the same rate which they were sold. In that case the only costs involved would be transaction costs (interest rate differentials and fees to the bank).

As the EMS was moving away from regular adjustments and towards less and less flexibility towards the end of the 1980s, its proponents in political and bureaucratic circles were hoping that co-ordinated interventions and swap arrangements would provide adequate cover against speculation. On top of this one had the interest rate weapon. This would particularly hurt those who speculated with borrowed money. Like we saw in chapter five, the Swedish central bank even raised its short-term rates to 500 percent at one point. As it turned out, however, none of this was sufficient. The currency market could, it almost seemed, mobilise unlimited resources, while there are limits to how far different states are willing to go in order to help each other. Furthermore, co-operation was not facilitated by disagreement over what the fundamental problem was. Was Germany too rigid in its monetary stance, had Great Britain entered at too high a rate, and how much austerity should countries like France and Italy have to accept in order to rescue the ERM? These were among the issues contested in the run-in to the crises of 1992 and 1993.

Two different but not mutually exclusive mechanisms have been identified as possible explanation for why it became more and more tempting for market actors to

enter into one-way bets against different EMS and EMS-linked currencies in 1992 (Sætre 1995, Thygesen 1997). The first mechanism is rooted in the fact that states that co-operate in exchange rate policy can still have divergent rates of inflation. If this is the case the economy with the highest rate will see its competitive position decline, it becomes economically vulnerable. In turn this will impact the current account, the country will run down its currency reserves, and an adjustment will be negotiated. That is, the stylised description just given, is close enough to how things used to work in the ERM. The Treaty of Maastricht – with its demands for two years of currency stability before a country could enter the EMU however, made the ERM more rigid (Sætre 1995:372). Thus weaker countries lost the safety valve the opportunity for adjustments represented. The corollary to this was an increased risk that currency traders would seek to force through an adjustment in stead.

The second mechanism is related to the political vulnerability that can emerge when countries have divergent business cycles and therefore divergent preferences in monetary policy. This is the same type of problem that we encountered in chapter five when discussing Norwegian exchange-rate policy from 1990 to 1992 (and again after 1994). The point is that Norway was not the only country uncomfortable with German monetary policy choices after re-unification. When the Bundesbank instigated its policy of interest rate hikes in 1991 most of (the rest of) Europe was in recession. This fired expectations among market actors that these countries had a limited tolerance for importing a pro-cyclical monetary policy from Germany. Crucially this is constellation that can easily set off a dynamic of self-fulfilling prophecies. In stylised terms: In the first “round” speculation motivated by a sense of political vulnerability will provoke higher interest rates in response. But in the next round these higher interest rates only compound the problem of pro-cyclical policy, which increases the chance that the speculators will be proved right. Eventually of course, they were in several countries all across Western Europe.

Returning to the Norwegian case, it seems likely that this sort of motive could have inspired speculation against the NOK in the autumn of 1992. The Norwegian economy was suffering as a result of importing German interest rates, and speculation

made matters worse by provoking interest rate hikes in response. But the social democratic government held out for as long as it could, and as we saw in chapter five, it did not even lose its belief in the blessings of a fixed exchange rate after the crisis. In a way it is ironic that the market actors lost their faith in the willingness of the Government to hurt the economy long before the Government lost their will to actually do so. I will return to this topic in chapter seven, when discussing whether the policies of bust were avoidable.

This chapter has been made up from a series of separate discussions, centred on each of the clusters of sources of disparate policy paths identified and developed theoretically in chapter two. In the next chapter I seek to draw the ties together at a higher level of abstraction. In that chapter issues such as was it really a policy fiasco, and what have we learned about the nature of institutional change will be addressed.

- *The generality of decomposition strategies suggests that the world is, in fact, only loosely interconnected, so sub-problems can be solved independently. But that very generality makes it likely that decomposition will also be attempted in situations in which it does not work.*

James G. March

Chapter 7: Broader theoretical issues – Institutional change and policy fiascos

This chapter consists of three parts. In the first subsection I return to the definitions presented in chapter one and discuss whether the Norwegian banking crisis can be labelled a policy fiasco. In the second subsection the findings made in this thesis are discussed in light of broader theoretical issues raised in chapter two. The previous chapter discussed theory and findings on a policy area by policy area basis. Section 7.2 seeks a higher level of abstraction and discusses the case as one. The third section is what I for want of a better term have called an analytical epilogue. Building on the material presented in the empirical epilogue in chapter five, it raises the question of whether developments post-1992 can allow us to speak of new routines making up a new, stable regime?

7.1 Economic mismanagement as a policy fiasco

In the introduction (section 1.3) a definition of policy fiascos was introduced. It included three criteria that must be satisfied in order to label a policy episode a policy fiasco. Furthermore, this definition had a cumulative element. The definition of policy fiasco contains a definition of policy failure. If the first two of the three criteria are met, we can speak of a policy failure. The three criteria are: (1) the establishment of an outcome as a negative event, (2) establishing a causal role for public policy in producing this event, and (3) that the political actions implicated by this understanding of causality were *avoidable* and therefore worthy of blame.

Marshalling the conclusions of several investigations into the crisis as evidence, I argued that the Norwegian boom and bust cycle and the banking crisis that accompanied it satisfies the first of these two criteria. Large groups perceived it as a major negative event. And there is agreement that policy co-caused the event. This means that according to the definitions developed in chapter one, this episode definitely qualifies as a policy failure. In this section I will discuss the third criterion – were these actions avoidable – as a way of narrowing in on the issue of whether it also was a policy fiasco.

When discussing this issue it is useful to distinguish between the politics and policies of boom and the politics and policies of bust. The point is that in hindsight there is substantial agreement that the policies pursued during the boom period were avoidable. There were viable and less costly alternatives, and there is no disagreement on this in the investigations. The problem is that these alternatives were simply not chosen before it was too late. I will recap briefly the most obvious of these, to the reader by now familiar cases. Tax reform could have been implemented earlier. Suggestions were on the table from as early as 1977, and the commission that was set up delivered its recommendations in 1984. Still nothing was done until 1987. With regard to interest rate controls we saw a similar story. Informed politicians refused to heed advice until the evidence against their positions reached crisis-like proportions.

As regards precautionary policy I rely on the benefit of hindsight when staking the claim that the choice to disregard the systemic management of risk was avoidable. This oversight, it was argued followed from biases inherent to the economist-technocratic discourse as it stood in the late 1970s and early 1980s. Still, as was argued in chapter 4, knowledge about the risk that accompanies a freer credit market was available in other disciplines -economic history to mention the most obvious. And *Bankinspeksjonen*, at least on one occasion, sought to draw the attention of its superiors to the causality that runs from increased competition to increased risk exposure in banking.

For all these cases we may add that the theoretical basis of the causal claims inherent in them are basic enough to be fundamentally uncontested. This is not an

obvious state of affairs: Economic theory and hence causal statements based upon economic theory are normally as easy to contest as they are difficult to disprove. That real post tax rates influence credit demand or that more stringent capital adequacy requirements would have hampered excessive growth and risk taking is, however, basic and uncontested economics. As a political scientist relying on economic theory in order to establish that the “episode” I study is a fiasco, it is important to stress the basic nature of the economics I invoke.

When it comes to imported dynamics and the policy and politics of bust, the story gets a bit more complicated. Because of changes in the external environment, the political room for manoeuvre was less in this period. Again this is something most observers agree on. Some observers however, have taken this point further. The latest commission looking into the crisis, and the only one led by a lawyer²⁶⁵, puts it like this when discussing the real rate of interest, the variable most people can agree upon was the key to the bust period (Dokument 17:51):

But the Commission fails to see that the increase in the real rate of interest reflected a desire on part of the authorities to conduct a tight interest rate policy. First of all nominal interest rates were tied up by the exchange rate. Secondly, the fact that inflation came down is the single most important factor behind the increase in the real rate of interest. But to maintain a high level of inflation in order to keep the real rate of interest down obviously does not appear as a favourable alternative to the course of events that were to unfold...

...This leads the commission to conclude that the main contribution of the authorities to the economic downturn and thereby to the banking crisis lies in what was done – or rather what was not done – in the period of the mid-eighties when growth was particularly strong.²⁶⁶

We see that the “Smith-commission” here links blame to whether or not there were viable alternatives. Finding none, the authorities are absolved. And on a general level it is difficult to disagree with the commission’s assertion that inflationary expectations in the economy needed to be broken. It is my contention however, that the commission is a bit simplistic when it discusses how this was done - how harsh the “medicine” needed to be. At this point the commission’s argument carries with it implicit assumptions and thus it requires examination at two stages (at least). First of

²⁶⁵ The lawyer in question is professor Eivind Smith, one of Norway’s most respected law professors and a man often used in public enquiries.

²⁶⁶ My translation.

all whether or not the exchange rate policy chosen was unavoidable until it crashed, and secondly given this, whether the target was wisely chosen.

To take the second step first. In chapter five I argued that the switch of exchange rate target from a basket to the ecu contributed to the downturn. This is because first the DM appreciated, then because EMS interest rates increased and finally because it meant that NOK got more directly involved in the ERM-crisis that started to run in earnest from the summer of 1992. This was unfortunate, and it is overlooked by the “Smith commission”, but in stead another type of defence of the ecu-policy can be erected. That events in Europe should take this turn was not foreseeable at the time the decision was made, thus the fact that Norway got so involved in the European debacle can be discounted as bad luck. Bad luck as a concept was not discussed in the theory chapter, but it should be related to the notion of whether the policy was avoidable or not. Simply put: to the degree that we accept the bad luck judgement, it weakens the case for describing the chosen policy as avoidable and thus blameworthy.

The first step of the argument of the Smith commission, however, is more difficult to accept. It is difficult to see that the rigid exchange rate policy needed to be defended for so long and, seemingly, at whatever cost. Because as we saw in chapter 5, there are no indications that the Norwegian government represented by its key actors, Prime Minister Gro Harlem Brundtland, and its Minister of Finance, Sigbjørn Johnsen, were entertaining notions of giving in at any stage. Even when the NOK ran into serious trouble in the currency markets in the fall of 1992, they held out as long as they could.²⁶⁷ The adjusted exchange rate regime – a more flexible approach to exchange rate management was forced upon them.

The strongest argument that the exchange rate strategy of the early 1990s was misguided and eventually contributed to the crisis can, however, be found in the words

²⁶⁷ An interview with the Minister of Finance, Sigbjørn Johnsen was published in Norway’s leading business paper (a daily) on the day the NOK was eventually forced off its peg. This means that the actual interview must have been made before the NOK was de-linked from the ecu. In this interview Johnsen talked about how the authorities had been successful in communicating what was done about the banking crisis to international markets and that he was hoping for (even) tighter links to the ERM in then near future, see *Dagens Næringsliv* 10.12.1992.

of one of its architects. As a top official in the Ministry of Finance, present Central Bank governor Gjedrem, was a key, if behind the scenes, actor in most of the policy processes discussed in the present analysis. He was directly involved both when the Ministry underestimated the upturn, and then the downturn. Furthermore, he played a role in the processes that led to precautionary policies remaining underdeveloped through the 1980s. He has not made any public statements addressing these issues directly. But as Central Bank governor it is now his duty to produce official views on exchange rate policy. In the first annual submission on monetary policy made under his stewardship the following statement about the relationship between exchange rate policy and the real economy is to be found:

The experience of the last fifteen years demonstrates that financial crises can often trigger or amplify cyclical fluctuations. Substantial and surprising changes in monetary policy can also trigger such financial crises. Norges Bank is of the view that also the concern for financial stability can best be promoted by focusing on the fundamental preconditions for exchange rate stability, avoiding abrupt shifts in interest rates.²⁶⁸

Seen together with this quote from the annual address (Gjedrem 1999:75) it seems obvious that Gjedrem has drawn lessons from the policy pursued in the early 1990.

...interest rates must not be set at such high levels that monetary policy contributes to economic downturns that undermine confidence in the krone. If unemployment rises sharply, market operators may perceive the exchange rate as being overvalued and that employment can be boosted by improving business sector competitiveness. This would tend to fuel depreciation expectations. A tightening of monetary policy in such a situation would not be credible, and might trigger renewed speculation against the krone. This mechanism came into evidence during the currency crisis in the autumn of 1992.²⁶⁹

If one accepts Gjedrem's implicit analysis of the early 1990s here, there is still one argument that can be raised to claim that these choices were unavoidable. That is that policy makers and their advisors could not understand this type of interplay between exchange rate policy and the real economy before they had experienced it. The economic historian Tore Jørgen Hanisch, who has studied Norway's costly

²⁶⁸ *Norges Bank's* submission on economic policy in 2000 (<http://www.norges-bank.no/english/publications/submission.html>).

²⁶⁹ The page number refers to the Norwegian version, the translation is by Norges Bank and taken from the WEB.

attempts at returning to the gold standard in the 1920's, thinks that there are obvious parallels between the two periods. He is of the opinion that policy makers could have acted differently in the early 1990s (Hanisch et.al. 1999: 359). Two arguments can be raised against this position. Firstly, the inter-war struggle to get back on the gold standard entailed undergoing a brutal deflation. The fixed exchange rate of the late eighties and early nineties entailed "only" disinflation. The second argument is that my own studies of the latter period have shown that there were very few voices raised against the fixed exchange rate policy, and those that were, only came in the fall of 1992 (Tranøy 1994a:193).

Again we come to a point where the concept of avoidable needs to be considered carefully. If consensus on a topic is encompassing enough, this weakens the case for describing the consensual choice as avoidable. On the other hand, Hanisch' critique of the hard currency approach is in principal the same as the one I have made concerning the bias against history, asset price inflation and precautionary policy. The underlying logic is the same. Contemporaneous consensus is not an "excuse" because there were lessons from the inter-war period available, but the parallels were not recognised by the decision-makers or their advisors. Should they be criticised for this oversight, is it indeed fair to describe it as an oversight? Ultimately this issue boils down to the quality of the parallels drawn. If it can be convincingly argued that Hanisch' or my parallel is flawed, and that the inter-war period does not hold the lessons that we claim it does, then our claims of avoidability dissolves. But the quality and relevance of historical parallels is an issue on which it is very hard to adjudicate.

In sum then, the policies that stimulated the boom were clearly avoidable and therefore they qualify for the label fiasco, while the policies of the bust period at a minimum qualify for the label of failed. In my view it is reasonable to take the full step and describe also the policies of bust as a fiasco, but this is a more contested and a more tenuous step.

7.2 Broader theoretical issues.

The theoretical interpretation undertaken in chapter six can be said to have moved on two levels of abstraction. The lowest level, that of the individual issue areas, and a medium level, when findings were compared within each type of disparate policy paths. In this section I wish to move on to a third level of abstraction and view the whole study as one case. The task is to summarise the findings and make more general observations of relevance for the theories understood as more overarching perspectives. Having done that I will also reflect on the larger issue of institutional change.

I will first discuss my findings in what in chapter two I called a closed polity context. The first issue that emerges here is that of statist versus pluralist perspectives. What the evidence from this study bears out is that to pose these perspectives as all-encompassing rival explanations is not a fruitful approach. What is needed is a “policy determines politics” approach to help understand what issues are subject to which forces. In the study of co-ordination breakdown this is particularly clear. The fact that different issue areas are subject to different dynamics is the key to understanding why coherence is replaced by incoherence. Still, one rough pattern is discernible. The technocracy was a more dynamic factor, more important as instigators of reform than any societal interest, as represented by politicians or lobbyists. And in issues where the technocracy lacked insight, politicians were also ignorant. At this level of reform (as opposed to smaller changes and petty favours one can suppose) the main role of societal interests is that of delaying reform.

A second observation of relevance for the statist-pluralist debate is that specific sector interests are difficult to attach to issues of macro-economic policy making and over-arching regulatory issues. It is more generalised or broadly shared societal interests which were at stake in the issues of interest rate controls and tax reform. This pattern of confrontation is well known from studies of states striving to increase their extractive capacity vis-à-vis civil society (Tilly 1975). But that was not the case here. Both the interest rate and the tax issue was motivated by governance concerns rather than a desire to extract more resources from society. And the distributive fault-lines of

these cases run within civil society, not between that and the state. Still, as we have seen, the political fronts that emerged did not reflect distributive fault-lines.

This can serve as a warning signal against undertaking elaborate attempts at deducing cleavages based on objective interests perhaps in general but at least in these two issue areas. By applying inductive insights and careful post-hoc reasoning however, some sense of these two issue areas could still be made in terms of interests. Partly because they realised that it was in the objective interests of a majority of their voters, Labour was willing – albeit feebly at first – to fight for tax reform. It is also interesting that, arguably at least, the Conservatives were least sceptical (although this does not say much) of higher interest rates. Interest rate controls and deductibility rules can from an economic point of view be conceptualised as two indicators that together form two thirds of the same variable – post tax real interest rates. But as the analyses showed, the most important source of stickiness on these two issues resided in different sides of the left-right axis.

The term complexity is frequently applied in the present analysis. This is worth further reflection. In relation to credit controls I have claimed that complexity paved the way for expert influence. Credit controls were difficult to understand. Therefore the public was not interested was – in simple terms – my argument. In the case of interest rate controls a different implication followed, namely that it touches the public in so many ways that it is hard for the analyst a priori to calculate how different groups in the electorate will react to change in it.

The permanent salience of the issue and broad-based opposition to higher interest rates is also fascinating. In almost every single issue analysed in this thesis the demand for lower interest rates is a common theme. Even in the cases of subordinated loan capital, and the ecu-link, actors with ulterior motives successfully launched this argument. The societal and therefore political aversion against higher interest rates may even help us explain the (erstwhile?) success of Central Bank governor Gjedrem's "coup" in 1999. The first time he applied his new formula for monetary policy it entailed lower interest rates. Politicians traumatised by the interest rate shock of the summer of 1998 grasped this chance of getting lower rates before the exchange rate

was back to the level specified by the exchange rate regulation. This, arguably, made it harder for his political task masters to withdraw his de-facto mandate at the next juncture when his strategy entailed higher rates than what would have been the case if the interpretation of the exchange rate regulation adhered to by his predecessor had been applied.

Actually, if we apply an objective interest mode of analysis a broad societal aversion against higher interest rates gets less and less tricky to explain over time. Net savers are to an increasing degree shifting their portfolios over from savings accounts - which benefit from high rates - to mutual funds and other instruments that tend to fall in value when interest rates go up. Having said this, we should keep in mind that interests can not always be taken as a given. Interests can also be changed through learning processes. This was arguably the case for Labour's voters in the case of tax reform.

The pluralist perspective in its most pure form entails at least two claims about politics that is worth taking issue with on the basis of the present analysis. One is the issue of proactive versus reactive manifestation of interests that I have discussed so far. The other is the issue of politicians' ability to rise above short-term electoral imperatives and parochial interests. The description of policy making in the 1986-8 period clearly brings out the expectation developed in the discussion of Katzenstein's work. In times of crisis Norwegian politicians get better at addressing bigger issues and gather around solutions that are deemed to be far-sighted and serving a more general good. A key here, perhaps, is the term "gather around". If unpopular choices can be made by way of consensual policy making, this reduces the costs for individual parties.²⁷⁰

²⁷⁰ Although I have not described the "rescue operation" that the Norwegian state set in motion in order to save the banks, it can be pointed out that this must in general terms be deemed a success. Like in Sweden, but unlike for instance in Japan, this operation was swift, decisive and successful in the sense that Norwegian banks were back on their feet making good profits after just a year or two. This invites a parallel to the "Katzensteinian" point made above. Because even though the Norwegian polity failed as a decision-making system in that it helped bring the crisis about, it also displayed great strength through its ability to produce a close to consensual rescue operation. When the crisis was manifest the key actors took a step back, managed to co-operate and co-ordinate and the political system responded in an admirable fashion.

I have less to offer on the theoretical implications of introducing outside-in factors to the analysis. To say that one must consider the external environment when analysing politics is not a theoretical statement. Still this level of analysis has become more important as international economic integration has proceeded, and this has added another layer of complexity to policy making and efforts at achieving co-ordinated policy. This happens both because states are directly confronted by market pressures, and because they chose to commit themselves to inter-state collaboration as a way of dealing with these pressures.

The EEA-agreement is a case in point. The analysis showed that from 1988 to 1992 influences from the European level dominated Norwegian economic policy making. But the EC/EU did not go away in 1992 when Norway unhooked the NOK from the ecu, neither did it disappear after the referendum in 1994 yielded a no-vote. To the contrary the EEA-agreement has created a firm basis for the three channels of influence (the legal, market and ideas channel respectively) to operate on. At the time of the last revision (March 2000) *Norges Bank* seems to have found a framework for its monetary policy that allows for a reasonable degree of co-ordination between incomes, fiscal and monetary policy. That issue will be discussed further in the next section.

The point here is rather that the permanence and breadth of Norway's ties to the EU makes it highly likely that new challenges to co-ordination will emerge from the European level in the future. If and when any number from the Northern European group of EMU-abstainers (Denmark, Sweden and the UK) eventually join, the framework for Norwegian Monetary policy will change again. It is difficult to predict what the consequences of such a development would be, but judging from past experience it does seem likely that it will impact Norway's room for manoeuvre.²⁷¹ One possible result is that trading in – and thus the volatility of - NOK will increase, as

²⁷¹ Norway's situation vis-à-vis the EU is not totally without resemblance to that of the man sharing a bed with the (proverbial) elephant. In the conclusion to our recent volume Claes and the present author (Claes and Tranøy 1999:291-294) argue that the EU is so influential on Norwegian policymaking that how the relationship is actually organised (membership, EEA or just a trade treaty) is of less importance than the political debate has to assume.

investors will be facing a dearth of non-EMU European currencies. Another is that if the EU as a part of the EMU-effort makes progress towards a common tax policy, this might well lead to a pressure on Norway to adapt its tax regime.

It is also worth reflecting on the EEA agreement in a co-ordination perspective. Whether or not the EEA is a sensible arrangement, is a highly politicised question. Supporters and opponents of Norwegian membership has attacked it from either side. While others yet see it as a handy compromise. My point is more narrowly related to the co-ordination agenda. Because to the degree Norway would have had a substantially greater say in EU policy as a member, the argument can be made that the present arrangement maximises the risk to co-ordination capacity. Because, arguably, the present arrangement provides minimal influence over policy-making in the European Union relative to the degree that Norway is obliged to incorporate EU-law into Norwegian law (Claes and Tranøy 1999:296-297).

Moving to a more concrete level, perhaps the single most important mechanisms that seem to entail a permanent structural constraints on policy making, is how the liberalisation of capital controls has increased the influence market actors over monetary policy. A particularly powerful expression of this can be found in situations where one-way bets are placed against fixed currencies. What the historical reconstruction has shown, however, is that the Norwegian polity as a decision making system is learning to live with this particular problem. National adaptation fronted by Central Bank governor Gjedrem has for the time being at least reduced the impact of this development on national policy making autonomy.

Finally, this concluding discussion must return to institutional theory. At the most abstract level, the present analysis has revolved around two questions that are also key concerns for institutional theory. Why do institutional orders experience periodic crises, and what is the relationship between crisis and change? In what follows, will try to sum up how my findings relate to these questions in the following.

In the introduction (subsection 1.2.1), two alternative perspectives on policy failure and fiascos were presented: A neo-liberal perspective that emphasises “too much state” and a globalisation perspective that emphasises “too much (international)

market”. The argument made here provided a different causal account of the policy fiasco under study. I do not wish to deny that both the number and complexity of the tasks undertaken by modern states, and the process of adaptation to rapidly internationalised markets, can give rise to great co-ordination problems. Indeed, it could be argued that the globalisation perspective to some degree is worked into my argument through the concept of “imported dynamics”. Still, based on the present analysis it is tempting to venture the idea that the greatest challenge to economic policy co-ordination faced by modern states arises when the relationship between state and market itself is renegotiated.

The empirical evidence from one single case study is obviously not enough to support such a sweeping claim. But that an idea cannot be defended in a proper manner does not render it meaningless to reflect upon it. First of all there are other cases that could be marshalled to defend this idea, but they have not been analysed here. A brief mention, however, can be made of some of them. Sweden left a credit regime very similar to the Norwegian one, at about the same time, and experienced a very similar sequence of events leading up to a banking crisis of similar proportions. Asset price inflation and delayed tax reform, insufficient supervisory policy and then “too much to late” as tax reform and an interest rate backed fixed exchange rate policy provided powerful counter-cyclical impulses just as the economy was receding.²⁷² More recently, and further away the Asian crisis has revealed a pattern of liberalisation, rapidly increasing risk exposure in the financial sector, and brutal interest rate hikes in an effort to prop up faltering currencies. This pattern played it self out in several countries. The currencies involved, like the Swedish and Norwegian before them, fell anyway, but in the process domestic demand shrunk, fast, contributing to massive recessions (Furman and Stiglitz 1998, Krugman 1999).

Given the design of this thesis however, the main argument linking liberalisation and policy fiasco would have to be theoretical. When the relationship

²⁷² For an approach similar to the one developed here on the Swedish banking crisis, see Tranøy (2000). For original Swedish research and documentation on the subject see for example Bankkriskommittén (1994 and 1995).

between political authority and economic activity is reorganised, all actors, in the economy and the polity, are confronted with multiple challenges and new rules of the game. When the cohesion secured by compatible routines are taken away, the polity becomes vulnerable to the centrifugal forces captured by the notion of disparate policy paths. Learning challenges abound, and the field necessary to overview in order to understand the relevant consequences of the choices made expands. But vision is not broad enough and learning tends to remain selective. Policy areas are functionally interdependent. Reform in one area has its counterpart in other areas, but sequencing tends to be decided by (asymmetrical) degrees of stickiness and not concerns over functional interdependencies. And finally, imported dynamics present new – or sharpen older - dilemmas between domestic and foreign economic policy making.

After discussing how failure is caused, we must turn to the relationship between crisis and change. This analysis took the punctuated equilibrium metaphor as an important point of departure. This strand of thinking posits that change is difficult to achieve, but that crisis leads to change. The notion is that pressures and inconsistencies will normally build up over a long period of time, before something gives. At this point a new regime emerges. Krasner (1984:242) speaks of :

...an imagery that expects short bursts of rapid institutional change followed by long periods of stasis...

There is thus implicitly an asymmetry between the process leading up to change, and the process of realising or implementing it. This analysis has emphatically illustrated the point that crises can be slow in arriving and that it (can) lead to re-orientation. A creeping performance crisis in monetary policy led to a technocratic reorientation away from the “Oslo-school”. The new consensus was presented by way of *Renteutvalget's* report in 1980. Then things slowed down again as new pressures built up within the issue area. Therefore the present analysis has also strengthened Herzog's (1989:39) assertion which was discussed in chapter two, that “upon closer inspection breaking points in history are often awfully long”. The short bursts are not so short and “bursty” after all. It was not before the oil price fall and the broader sense of economic crisis took hold that the process of regime change reached its defining moment and started gain real momentum again.

It should also be recalled that the process studied here involved several institutional actors with different degrees of substantial impact on different policies. Thus “my” breaking point in history becomes “awfully long” partly because of this spatial dimension: Upon closer inspection “my” breaking point can actually be broken down into several smaller breaking points, one for each issue area. And this spatio-temporal division between policies, the disparate policy paths, was the source of flux and confusion. If we maintain that the oil price fall of 1986 was the defining moment of the process of credit regime change this can be stated slightly differently. There were drawn-out processes at both sides of the defining moment. Tensions built up before 1986 were released in the compromise over tax policy and the reorientation of monetary policy, but this in turn created new problems. It took until the end of the 1990’s before new and what looks like more coherent routines were in place. To what degree this is the case, is the subject of the last section of this chapter, the analytical epilogue.

7.3 Analytical Epilogue – new stable routines?

In this last section I raise the question if, from the vantage point of today (March 2000), we can say that the “punctuation period” is now over. Is it meaningful to speak of new routines making up a new, stable regime? The best time to answer this question, of course, would be sometime in the future. It lies in the nature of the phenomenon I am interested in here – stability – that it can only be observed over time, and preferably in hindsight, that is after new change has set in to form a contrast. Still, I will try to shed some light on the question by trying to evaluate how promising the emerging practices look in terms of co-ordinating functional interdependencies across issue areas.

Driven forward by an interest in (problems of achieving) co-ordination, this thesis has sought to cover an extremely broad field of issues and policy areas. The analysis has ranged from issues of tax, and prudential regulation, and even bank

strategy, to macro-economic policy regimes. In this section only a brief mention of other areas will be made before I move on to concentrate on the macro issues.

What needs to be said about non-macro issues here is that the crisis period studied here seems to have borne some fruits in the shape of lasting and worthwhile lessons. As we have seen, a tax reform reducing deductibility of interest rates to 28 percent of their gross worth is now in place.²⁷³ This means that the Central Bank's ability to conduct an effective monetary policy is much greater now than it was in the period of hyper-growth. At that time the corresponding percentage was almost 70 percent for high-income groups and around 50 percent for average incomes. Secondly precautionary policy is strengthened. Risk weighted capital adequacy requirements have been harmonised with international standards. Seen in light of the experience of the mid-1980s it is more significant, however, that the salience of capital adequacy and prudential regulation as an issue as such has been accepted. The status of the precautionary body has risen and it has now got a well-respected, politically experienced and relatively high profile leader.²⁷⁴ When the 96-98 upturn started to look like a boom with a great surge in lending, *Kredittilsynet* demonstrated that it now has the ability to react early and so firmly place issues of risk and risk management on the agenda.²⁷⁵ Finally, it should be mentioned that households seem to have learned. Indebtedness-levels have not returned to the levels they reached during the mid-eighties boom, even after the housing market took off from 1994 and onwards with yearly price increases measurable in double digits.

²⁷³ Strictly speaking I have been interested in the deductibility rules of the tax system because of its implications for macro-governance. I still chose to treat it here, rather than below because it was processed as a structural measure and is not an instrument available for discretionary macro-governance.

²⁷⁴ *Kredittilsynet*, has since 1993 been lead by Bjørn Skogstad Aamo, former state secretary and key aide in economic policy to Gro Harlem Brundtland from 1986 to 1993. In 1999 Skogstad was re-appointed for another 6 years.

²⁷⁵ *Kredittilsynet* suggested to tighten its control of banks by raising core capital requirements. Banks with core capital below 7 percent (the BIS-requirement is 4 percent) would be hindered from issuing new loans or distributing dividends. On top of this it wanted the right to throw out boards and fire managing directors, if core capital fell below 5 percent. These suggestions were extreme, and they were not adopted. That is not the main point however, because it is not clear whether they were meant

Regarding the macro-regime and the issue of co-ordination, the period began with the introduction of the “Solidarity alternative”.²⁷⁶ This was important for at least two reasons. First of all it represented an attempt at designing a coherent strategy for Norwegian macro-economic governance. It was born of the crisis at the turn of the last decade, and as such it represented a widespread realisation within the policy-making elite that economic management had gone astray in the mid- to late eighties. Second, the “Solidarity alternative” worked well under the conditions that held sway in the 1993 to 1995 period. Although this was not a part of the “Solidarity alternative”, it should also be added that this period so the ushering in of new routines for surveying macro economic developments. From the mid-1990s and onwards the technocrats have been keeping a keen eye on changes in indebtedness levels and saving and borrowing patterns in general, as can be witnessed from budgetary documents and publications from *Norges Bank*.

8 years after it was first suggested, it seems plausible to categorise the “Solidarity alternative” as the latest stage of the transition period. Strictly speaking there was not much new about it, more a return to old values and practices spiced up with the odd new element. The most novel aspect of it, in fact, was to employ fiscal policy more actively in demand management. This is, of course, an old idea. But as we saw in chapter two (subsection 2.1.2), in the discussion of the Social Democratic Credit Regime, there was no real tradition for fiscal activism in Norway. Counter-cyclical spending was tried in the mid-seventies in an effort to ward off the effects of the international recession of the time, but this was called off after a few years. To the degree that the Norwegian regime of the post-war era was counter-cyclical, this was accomplished through credit policy: by loosening up on credit controls when the business cycle was deemed to be falling off.

to be taken seriously in themselves, rather the point was to send a powerful signal and to ruffle some feathers, and if this was the goal it probably was achieved.

²⁷⁶ As pointed out above the “Solidarity alternative” encompassed much more than the notion of a division of labour in macro-policy between fiscal, monetary and incomes policy. When I speak of the “Solidarity alternative here, however, I refer only to this aspect of the policy package.

Exchange rate policy under the solidarity alternative was a case of a new idea modifying an old practice. The new idea, the receptivity for which was secured by the 1992 experience with increased capital mobility, was the fear of presenting the market with one-way bets. This implied a more flexible approach to what was still largely a fixed exchange rate. Finally, incomes-policy represented more or less a return to old ideas and practices. The incomes policy part of the “Solidarity alternative has been described as a “re-nationalised cooperative practice”. As we saw above, this set of policies worked well while the economy was still in a slump: high unemployment facilitated moderate income settlements, and counter-cyclical *spending* proved easy to achieve. It was also fortuitous that the Norwegian and the European business cycles were converging around 1994 and 1995, which meant that the import of monetary policy from Europe did not cause any noteworthy disturbances.

From 1996 and onwards, however, weaknesses in the system began to appear. As it turned out the principles of the “Solidarity alternative” became more difficult to apply as the upturn caught on. Counter-cyclical fiscal policy was more easily achieved as long as it implied spending increases rather than cuts, and wage moderation was more easily achieved while unemployment was high. This could be because high unemployment can fill trade unionists with a sense of purpose and more prosaically because shortages in the labour market leads to a bidding up of wages. To make matters worse for the “Solidarity alternative” the NOK got stronger during the upturn, while the continental economies were still in a slump. As we have seen, this meant that interest rates had to be cut in line with German interest rates in order to stabilise the exchange rate against upward pressure.

Central Bank governor Gjedrem’s formula for avoiding these types of conundrums in the future is, as we have seen, to establish a policy hierarchy with the instrument he has assumed control over – monetary policy – on top. Above I argued that the societal interests that ultimately shape fiscal and incomes policy (democratically elected politicians and trade and employers union leaders respectively) might be responsive to disciplining from empowered technocrats in the Central Bank. This is broadly speaking in harmony with the kind of analysis made in the literature

that was presented as pessimistic view of democratic governance of the economy in chapter two (subsection 2.2.3.3). The general notion is that governments respond to short term electoral “imperatives” when making fiscal and monetary policy and therefore need to insulate monetary policy/and or establish a more rule-based fiscal policy routine. To this picture can also be added studies of wage formation emphasising collective action problems and the inflationary consequences of these.²⁷⁷

Essentially all these literatures are about co-ordination. A key question is, what kind of institutional set up can facilitate co-ordination across different interests so that (societal or what economists call welfare) gains can be achieved. Most often gains are conceptualised in terms of reducing inflation with no or minimal impact on employment. If we introduce some auxiliary conditions, we can use elements of this literature as a yardstick when discussing the co-ordination potential between fiscal, monetary, and incomes policy if the principles Central Bank governor Gjedrem has ruled by so far are indeed established as routines. Within this theoretical context I will briefly discuss the relationship between the kind of de-facto central bank autonomy that Norway has at the time of writing and fiscal and incomes policy in turn.

The view of fiscal policy inherent in the original pessimistic literature is crude and not very nuanced. Elected politicians are generally said to be bad at producing fiscal restraint if given too much discretionary power. This kind of general proposition does not sit easy with the fiscal track record of Norwegian governments from the war and until the mid1960s. Very powerful Labour governments dominated this period of Norwegian political history. Most observers would probably agree that Labour wielded its power in a decidedly discretionary manner. Still, as described in chapter two, fiscal restraint (i.e. budget surpluses) was the trend. Later on, however, institutional variation has been introduced to the study of fiscal policy. A common finding from this literature is that it is more difficult to hold Government deficits and debt down when the state and the party system is fragmented. This is so, to put it simply, because co-ordination and balancing of competing demands is more difficult to achieve when power is

²⁷⁷ The literature on wage-formation and institutions is vast. A classic early text is that of Cameron (1984). A much quoted contribution is that of Calmfors and Driffill (1988).

fragmented (Alesina and Perotti 1994). The Norwegian state is traditionally understood as unitary and the party system is neither particularly fragmented nor concentrated (Lijphart 1984:178, 122). Still, it is my contention that the gist of the argument about co-ordination fits the observation that relatively weak minority and/or coalition governments have become the rule in Norwegian politics over the last 30 years. And, as we have seen in chapters three, five and in this chapter, cabinets resting on such foundations have tended to have trouble in producing fiscal restraint.²⁷⁸

As Einar Lie (1998:83-85) has pointed out, Labour has a tradition for showing restraint in power. This has often been achieved with the help of the Conservatives who tend to feel obliged to support a fiscal stance that can help keep taxes down. But in a situation where Labour seems to be stabilised at a level of support between 30 and 40 percent, the result seems to be weaker governments and a greater diffusion of power. The centrist parties on their part are more “pet policy parties”. If they are not ruling themselves, their support comes at a fiscal price. And when they rule themselves, as from 1997 to the time of writing, the cabinet is shafted on a small minority and the situation is fluid.²⁷⁹ Given that the cabinet-parliament relationship has changed permanently, self-binding through giving the Central Bank the power to punish politicians by way of interest rates may be an adequate tool for improving co-ordination between fiscal and monetary policy. The new budgetary procedure (see chapter 5 subsection 5.5) might also make it easier for Parliament use fiscal policy as a macro economic instrument.

²⁷⁸ The last majority government Norway had was Willoch’s second cabinet (1983-85). It could be argued that this government was a majority government also in the years when the Conservatives ruled alone (1981-83) because of the solid support it enjoyed from its later coalition partners. The most interesting fact about this government’s fiscal performance is, however, how it gradually lost control over public spending in its later years. And as a corollary to this – its lack of enthusiasm for administrating the cuts that all parties agreed were necessary in one way or the other in spring of 1986 (see chapter three). The last majority government before this was the non-socialist coalition led by the Centre-party’s Per Borten from 1965 to 1971. This was not a government of great restraint either. Commenting on this government’s performance, Hanisch (1996:178) remarks that “never before had public expenditure grown so fast during peace-time.” Eventually, the post-war tradition of the Labour cabinets that had been hegemonic in Norwegian political life until 1965 of running fiscal surpluses was broken by Borten’s government.

²⁷⁹ This fluidity has been elevated to ideology – or at least a strategy – by the centrist parties. Their Government spoke proudly of their independence from the established “blocks” of political life.

A similar kind of logic applies in the case of incomes policy. In its first formulations put forward by economists, the argument that linked inflation performance (with a given unemployment rate) with degree of central bank independence was mono-causal in structure and built on rational expectations foundations. Later, political economists have developed the argument that the relationship between central bank independence and inflation performance is better understood as resulting from an interaction effect with the system of wage determination. More specifically this emerging literature emphasizes the importance of co-ordinated wage bargaining systems as facilitators of an effective signalling process between the central bank and wage setters (Hall 1994, Hall and Franzese 1998:511). The main implication is that:

...where wage bargaining is co-ordinated, the central bank may be able to influence the level of settlements and reduce inflation simply by signalling its policy intentions so that monetary policy does not raise unemployment

This is in contrast to uncoordinated wage bargaining systems. In such systems each bargaining actor is too small to expect direct reactions to its particular settlement. And where they furthermore face disincentives to show moderation of their own accord because of collective action problems. In such a system maintains Hall and Franzese, the central bank may well have to actually implement a policy of tight money and thereby contribute to higher unemployment.

As we have seen, Norway has a highly co-ordinated wage bargaining system, but under the solidarity alternative wage moderation has been difficult to achieve when labour market conditions got too tight. This indicates that a central bank able to send out credible signals (or threats) and pulling in the same direction as the trade union leadership, could achieve more versus the rank and file of trade union members than a leadership working on its own. On its own, without a quasi-independent Norges Bank to supply threats, trade union leaders cannot do much more than argue for what its sees as a collective good and appeal to the principles of the “Solidarity alternative”.²⁸⁰

²⁸⁰ As was stated already in chapter one, the organisational and normative underpinnings of incomes policy have not been analysed anywhere in this thesis. This was a choice made in order to keep an already unwieldy analysis less complex. Still, I cannot part from this issue without mentioning that at the time of writing the organisational landscape of organised wage earners is in

Having thus discussed the possible co-ordination gains to be achieved with a regime set up along the lines Gjedrem prefers, might similar results not be possible with the routines of the “Solidarity alternative”? In short, the answer is no. The net effect of “irresponsible” wage settlements or fiscal policy may *sometimes* have been similar (that is, higher interest rates), but under that regime the effect had to come by way of the currency market and the exchange rate. That is, *Norges Bank* did not control the situation. Given a wage settlement or a budget that it did not like, it had to hope that the currency market would react negatively bringing the exchange rate under pressure so that it could employ the interest rate weapon. But as we have seen, the exchange rate is determined by more factors than incomes and fiscal policy, the oil price being perhaps the single most important exogenous factor. Under such conditions, the threat of interest rate hikes (i.e. “the signalling process”) is much less credible than the one Gjedrem wields with the current de-facto regime.

Thus the conclusion to this epilogue is that a macro regime underpinned by a de-facto independent central bank is a solution with the potential to increase the degree of co-ordination between functionally interdependent policy areas. If we compare this to Social Democratic Credit Model we can say that the world has been turned on its head. The rate of interest used to be a political goal. Other policies were compatible with this fact of political life. Technocratic governance secured tight credit and capital controls, while majority governments produced fiscal moderation, all of which

flux. In a recent article Dølvik (1998:37), a leading authority on this subject, summarised the arguments that point towards a long term decay in the ability to produce co-ordinated bargaining by pointing to the following factors: 1) “Changes in the relative share of union membership between the different confederations and intensified inter-union rivalry”. 2) The advantage taken of the economic boom by groups of managers, independent professionals and share-holders. This according to Dølvik, has weakened union support for continued ‘solidaristic moderation’. 3) Dølvik also claims that there is “dissatisfaction among union confederations who feel they have been disempowered by LO and NHO’s hegemony in wage policies” 4) Dølvik also point out that “groups of well-educated employees in the public sector, referring to declining returns on education, feel they have lost ground because of the flat wage increases of the ‘solidarity alternative’.” 5) Dølvik’s last point is fragmentation among the professional confederations. It should be added that Dølvik also saw some arguments that could support a more optimistic view on behalf of those who would like to see co-ordinated wage bargaining and wage-moderation live on. “. . .not least the prevailing collective bargaining hegemony of LO unions in the private sector and the government’s ability to curb industrial conflict by compulsory arbitration”.

contributed to controlling the level of credit in the economy with a minimal use of the interest rate. Now the rate of interest has become the ultimate technocratic tool. First it was taken away from the politicians and linked to the exchange rate. Now it has been relieved of the responsibility of single-handedly taking care of the exchange rate, transferring more of this to what Gjedrem call the “fundamental conditions for exchange rate stability”. In reality this means that fiscal and incomes policy has to produce the goods, or else the interest rate weapon will be applied.

All this leaves us with one major, as of now unanswerable question. Has Norway really established technocratic governance over interest rates as its prime institutional principle for governing a more market based and internationalised economy? Gjedrem’s new regime has not been formalised. The closest it has come is the submission for 2000, which was as we saw signed also by the bank board’s political appointees. No constitutional initiatives have so far been made in order to secure Norges Bank a higher degree of formal independence. The law of 1985, which in reality codified realities as they had been under the Social Democratic Regime, is still the legal document which regulates the relationship between the Central Bank and parliamentary democracy. Gjedrem’s achievements so far have astounded many observers, including this one, and his authority is strong. But it is personal, and therefore vulnerable.

Appendixes

Appendix I: A chronology of events in the history of Norwegian credit market regulation and macro economic policy (1951-1999)

January 1951: *Samarbeidsnemnda*, a bi-partite arena for corporatist negotiations between the authorities and representatives of the private financial institutions, is established. The authorities wanted to address three major problems. Secure and cheap funding for the state-banks, maintaining low interest rates even though the post war liquidity overhang was being reduced, and modify investment activity without hurting purposes targeted as important for reconstruction.

1955-1960: The associations of the insurance companies are brought into *Samarbeidsnemnda*. A practice of better (but not fully) specified one-year agreements serving two purposes is established. These purpose are a) Restricting the supply of credit from the private institutions when the business cycle “demanded” this, and b) a commitment on part of the institutions to buy state bonds for state bank funding.

1961-65: *Samarbeidsnemnda* develops a framework agreement for continued negotiations while new legislation for governing the credit market is being prepared. The activities and concerns of *Samarbeidsnemnda* are the same as in the previous period.

1965-66: Against the wishes of the Central Bank and the private financial institutions a new law, *Penge- og kredittloven* is enacted in July 1965.. The key instruments of the new legislation were adjustable primary and secondary reserve requirements that were meant to regulate the liquidity of the banks thus, in theory, enabling the authorities to release the optimum volume of credit at any given time. For periods of very strong credit demand there were supplementary reserve requirements that were meant to

function more or less as direct controls. The associations of the private financial institutions withdraw from *Samarbeidsnemnda* to signal their protest. The incoming non-socialist coalition government (which had fought the new law while in opposition) introduces its instruments at the first available opportunity - the budgetary year of 1966. In practice the regime thus established to regulate the volume of credit is to last with only minor modifications for 18 years. Interest rates level however are still negotiated and in 1966 and 1970 new corporatist type institutions are established to handle this issue in particular. A feature of the coming years is gradually increasing inflation, increasing marginal tax rates and as a result falling real interest rates. A second feature is a gradual increase in the scope of credit market regulation. This is a response to new types of institutions and products that are introduced in order to circumvent legislation.

1972-76: As the Bretton Woods exchange rate regime collapses in 1971-73, the NOK seeks refuge in the European co-operative project “the snake”. Thus NOK is revalued several times with German marks leading the way. As it turns out this is the only factor - other things equal - contributing to lower inflation in this period.

1975-77: The post-Bretton Woods and OPEC 1 downturn is met with highly expansive “bridging policies”. Fiscal policy, credit policy (particularly through the state banks), incomes policy and North Sea investments all contribute to the expansive climate. The results are high real wage growth, a large fiscal deficit, increased inflation, record high deficits on the current account and falling real post tax interest rates. In September 1977, after more than 25 years of continuous operation, interest rate regulation is suspended. Rates are allowed to rise by two percentage points as part of an immediate package to stop increasing inflation and a record high deficit on the external balance. To appease parliament where several influential figures reacted to having 25 years of regulation abandoned by “the stroke of a pen”, a broadly based committee of inquiry *Renteutvalget* is established to discuss the future of Norwegian credit policy more thoroughly

1978: In September a wage and price freeze that also includes a freeze on interest rates is instigated to fight inflation and the external deficit.

1979: Norwegian banks are granted a more liberal access to foreign exchange markets. The long term effects of this reform proved to be profound as banks availed themselves of this opportunity in the early stages of the growth period 1984-85 when confidence in the NOK was high and access to foreign short-term funding was good.

1980: *Renteutvalget* delivers its report in January. The most important conclusions are: That to achieve control with credit supply a more flexible interest rate policy is necessary and this should replace the use credit controls for managing credit supply. Concrete steps suggested are that the market for bonds should be liberalised and that this rate and the money market rate should serve as cues for a market oriented but administratively estimated interest rates declared by the authorities. In April the four major parties of Parliament express a fundamental support for the principles of *Renteutvalgets* report as two of the most important measures suggested were included in the revised budget for 1980. These measures were a partial liberalisation of the bond market and the introduction of a system of interest rate declarations that only covered loans, banks and other institutions were in principle free to compete on deposit rates. Credit controls are still being used however.

1982: The new conservative government of 1981 stimulates the stock exchange by a series of liberalisation measures and tax breaks. The market enters a long boom phase and the index grows by nearly 100 % in 1983. Simultaneously prices in the housing market are given a significant boost as the market for co-operative homes is liberalised. The market for business property grows even faster.

1983: A new fast-track committee reports on the state of the credit market and concludes that the market conditions are sufficiently balanced for credit controls to be

repealed. The conservative government is expanded into a coalition government, including the Christian democrats and the Centre Party. Particularly the Centre Party is committed to keeping interest rates down. Fiscal policy gradually becomes less tight under the new government. In July the Central bank suspends its most severe tranche, thereby making the access to Central Bank funding much easier for the banks. The supervisory body, *Bankinspeksjonen*, produce an analysis that emphasises the positive relationship between increased competition increased credit risk and banking crises. It also points out a need for the banks to be allowed to build up bigger loan-loss reserves. The analysis is ignored.

1984: The Central Bank lifts its most direct controls on the lending of the banks and other financial institutions in January. The bond market is truly liberalised. The (net) supply of credit immediately responds and increases by a yearly rate of more than 50% from 1983 to 1985 and it continues to grow fast until 1987. Overshooting compared to government plans reach absurd levels (more than 100 percent in some years). Norwegian nominal rates are now comparatively high and most of the increased lending is funded abroad, as banks can now take advantage of the rule changes implemented in 1979. The major commercial banks only manage to maintain their capital ratios by bringing in subordinate loan capital from abroad. Capital controls are loosened, but not abolished all together. Structural policy (regulating “branching”) is also liberalised and the banks build up their presence in different regional markets fast.

1985: Interest rate declarations are discontinued in the autumn. But at the same time the government instructs the central bank to keep the money market rate within a narrow band (12-12.5%). As the price of oil and the external balance takes a dive, the trust in the exchange rate falls. Consequently, foreign funding for the credit market dries up and the central bank is (during 1986) forced to increase its funding of the banks by a staggering 72 billion (thousand million) NOK to secure that money market rates stay within the assigned band. Moderate (and inefficient) credit controls in the form of liquidity requirements are gradually increased.

1986: Even though the full extent of the credit driven boom is not appreciated, a perception of loss of control over the credit market is getting stronger in the Ministry of Finance and direct controls over bank lending (supplementary reserve requirements) is reintroduced. World oil prices plummet. Norway's previously strong current account balance deteriorates badly. An expensive reduction of working hours is agreed upon in the wage settlements in the spring. The incoming labour government devalues the NOK by approximately 10 percent in May, after sustained speculation. Fiscal policy is tightened through spending cuts and tax increases. The supervisory body suggests allowing the banks to build up bigger loan-loss reserves - the call is ignored. Capital controls are tightened somewhat to ease pressure on the exchange rate. Inflation picks up again breaking a 5-year downward trend. There is renewed speculation against the NOK during the autumn and on the advice of the governor of the Central Bank the government decides to pursue an inflexible exchange rate strategy. As of December the interest rate is directed solely towards defending the value of the currency. Money market and bank lending rates rise by more than 2 percentage points. The credit-boom still continues however. The three biggest banks increase their equity base by including perpetual subordinated loan capital in addition to regular subordinated loan capital. They apply for the right to let the total sum of perpetual and regular subordinated loan capital corresponds to 100 percent of their real equity. The request is granted the next year, implying that a good opportunity for curbing growth in bank lending is spurned.

1987: After many years of political struggle part of the income tax is now calculated from gross income. Thus the value of tax deductibility of interest rates is reduced, and together with the increased nominal rates this contributes to rising real post tax interest rates despite increasing inflation. Fiscal policy is tight. Norway's biggest bank (DnC) report massive losses on securities trading and some minor banks report very large losses on bad loans. The supervisory body again suggests allowing the banks to build up bigger loan-loss reserves – again the call is ignored. Rules for loan loss provisions are made more stringent.

1988: All remains of the social democratic credit model are formally given up. The credit budget is discontinued and credit controls are no longer used. The EEA-process is initiated, and Norwegian policy is increasingly oriented towards Europe. Three smaller banks lose their equity capital and receive support from guarantee funds. A moderate wage settlement is reached between the main confederation of workers (LO) and the employers organisation. The Government generalises this settlement to the rest of the labour market by law.

1989: Increasing oil production and a good export performance brings the current account back to a surplus. Fiscal policy is expansive in an effort to combat the deep recession. But European interest rates are increasing, thus lifting the “floor” for Norwegian rates. Together with a falling rate of inflation and the phased in tax reform this means that real interest rates keep on rising. The credit supply is negative as the public give priority to reducing their expensive indebtedness. Norway’s biggest and third-biggest commercial banks are allowed to merge, mainly because the biggest (DnC) is perceived as being on the brink of failure. Still, the general picture in policy-making circles is that the Norwegian economy is taking a “hard landing” rather than crashing. For the third and last time the supervisory body suggests allowing the banks to build up bigger loan-loss reserves. For the third time in four years the call is ignored. Unemployment increases.

1990: In July capital controls are phased out in line with the timetable for the EC’s internal market. Private individuals are now free to speculate against the NOK. In October the outgoing (one-year-old) non-socialist coalition government links the NOK unilaterally to the ECU basket. Thus German Marks come to weigh more heavily in the Norwegian currency basket, and Norwegian interest rates stay high along with the EMS countries. Real post-tax rates reach the 4 percent level for average incomes, (which is a post war record). Real estate prices plummet. The troubles of the financial sector take on new proportions as the three (four, if we disregard the merger the year

before) major commercial banks (and many other financial institutions) report enormous losses in the 3. and 4. quarters.

1991: In March the own funds directive of the EC specifying stringent capital adequacy requirements and more stringent loan loss provisions are enacted, which contributes to making the financial position of the major commercial banks even more perilous. In December the state has to rescue all three major commercial banks, and is left with a 100 percent stake in two of them and as the majority owner in the third. Unemployment approaches 6 percent, and unheard of figure in post-war Norway.

1992: Tax reform is agreed upon, bringing real post tax interest rates upwards, so that they go above 6 percent for average incomes. In the autumn, as wave after wave of exchange rate turbulence sweeps over Europe, nominal rates are pushed further upwards but then, NOK is finally forced off its ECU-peg in December. Interest rates begin to come down and the road to recovery for both the financial sector and the economy begins. A broad-based “Employment commission”, led by Per Kleppe, developed the so-called “Solidarity-alternative”,(NOU:1992:26). In macro-economic governance the committee suggested a division of labour between the three key policy areas. Fiscal policy was to be used to control aggregate demand. Incomes policy should take care of improving competitiveness while the task of monetary policy should be to stabilise the NOK against European currencies

1993: Conditions were conducive to realising the ambitions of “Solidarity-alternative”. A record high unemployment rate indicated that fiscal policy should not be too tight. The unemployment situation dampened wage demands from organised Labour. Real (disposable) incomes received a boost from falling nominal interest rates. Formally the NOK was enjoying a “provisional float” but was basically left alone by the market.

1994 A new slightly more flexible exchange rate regime for NOK was formalised in the Government’s exchange-rate regulation. The exchange rate should be kept stable

vis-à-vis European currencies, but with non-publicised margins of fluctuation and no obligation to intervene in the currency market for the Central Bank. Thus it became more difficult for market actors to make “one-way bets” The new strategy entailed that interest rates were still bound up –if not to the same extreme degree as before – in stabilising the exchange rate against European currencies.

1996: Norwegian growth is strong and unemployment comes down. The wage settlements in the spring are far more generous than the principles laid down in the “Solidarity alternative” suggested. Norway’s business cycle is deviating more and more from continental Europe, where growth is sluggish. Europe continues to have low interest rates, while *Norges Bank* would like to increase Norwegian rates, but it can’t do so for fear of currency appreciation. Fiscal policy is tightened somewhat

1997: The economy is heating up, but fiscal policy is neutral. The Central Bank has to cut interest rates in order to keep the NOK within the upper limits of its “target zone”. Arguing that monetary policy is clearly pro-cyclical *Norges Bank* suggests a more flexible exchange rate strategy to make room for interest rate increases but is rebuffed by the new centrist Government.

1998: The economy is growing fast, but fiscal policy is still neutral. The wage settlement in the spring is among the most generous of the post-war era. Oil prices fall, and world economic turbulence – “the Asian crisis” and related crises in Russia and Brazil - catches up with Norway in the summer. The NOK comes under pressure and room is created for the Central Bank to increase interest rates with 3.75 percent in the space of two months. The interest rate shock creates a lot of political noise, but neither unemployment nor housing prices suffer. A tighter state budget for 1999 is agreed upon in Parliament.

1999: The new Governor of *Norges Bank* and former Secretary General in Ministry of Finance, Svein Gjedrem, reinterprets the exchange rate regulation as soon as he arrives

in his new job. He claims that from now on focus must be on long term preconditions for stability, not day to day movements in the market. He is not rebuffed by his political task masters. With this “coup” he creates room for a more independent interest rate policy. Among his first acts is to lower rates before the NOK is back in its target zone. In the autumn he refuses to cut rates more, even though the NOK by now is stable above the old target as the ecu continues to decline against the dollar.

Appendix II – list of interview subjects

Mats T. Andenæs. Professor of Law, Kings College, London. Deputy Director General, Assistant Director General and Principal Officer, Ministry of Finance 1987-1992. Interviewed at Humboldt University (Berlin) 21.07.1998

Arnulf Arnøy. Vice president, Kreditkassen 1987-91 (Strategy, Equity and Long Term funding). Executive vice president, Eksportfinans 91- (Risk Management). Interviewed at Eksportkreditt 16.01.98.

Gunnar Berge. Minister of Finance 1986-89. Chairman of the Standing committee on finance of the Storting (the Norwegian parliament) 1978-81. Interviewed when Chairman of the Labour Party's parliamentary group, at the Storting 1.6.92.

Jarle Berge. Project Manager and Director, Norges Bank 1977-96. Vice-governor, Norges Bank since 12.04.1996. Secretary General of "Renteutvalget" (1978-80) and member of "Klepeutvalget" (1987-89). Interviewed at Norges Bank 10 and 15.06.1992.

Petter Jacob Bjerve. Chairman of "Renteutvalget" 1978-80 (NOU 1980:4). Minister of Finance 1960-63. Director of "Statistisk Sentralbyrå" (Central Statistical Office) 1949-80. Interviewed at Statistisk Sentralbyrå 26.05.1992.

Eivind Erichsen. Secretary General, Ministry of Finance 1958-85. Director, OEEC 1956-57. Interviewed at the Ministry of Finance 02.06.1992.

Jo Forfang. Lawyer, Norges Bank. Secretary General of "Bankkriseutvalget" (NOU 1992:30). Interviewed at Norges Bank 16.01.1998.

Einar Forsbak. President of the Norwegian Association of Saving's Banks since 1979. Member of "Mål og Virkemiddelutvalget" (NOU 1983: 29). Worked for IMF 1968-71 and Norges Bank 1964-67 and 1971-78. Interviewed at the Norwegian Association of Saving's Banks 11.06.1992.

Svein Gjedrem. Several key positions in the Ministry of Finance since the late 1970s, including Secretary General. Head of "Mål og Virkemiddelutvalget" (NOU 1983: 29). Governor, Norges Bank since 01.01.1999. Interviewed in the Ministry of Finance 17.06.1992

Egil Gade Greve. Administrative Director, Bergen Bank later (DnB) 1980-1992. Member and director of the board of the Norwegian Bankers Association in several intervals during 1980-90. Interviewed at Grand Café, Oslo 12.06.1992.

Arnt M. Henriksen. Member of "Kleppeutvalget" 1987-89. Member of Parliament 1973-77 and 1981-89. Member of the Standing committee on finance of the Storting 1981-89. Interviewed on the telephone 22.06.1992.

Harald Henriksen. Managing Director, Industribanken (1979-93). Regional Director, Distriktenes Utviklingsfond (1960-70). Managing Director, Strukturfinans (197079). Interviewed at Industribanken 11.06.1992.

Erik Lind Iversen. Advisor, Kredittilsynet. Held various positions in Bankinspeksjonen and then Kredittilsynet (1980-). Interviewed at Kredittilsynet 04.03.1998.

Per Kleppe. Minister of Finance 1971-72 and 1973-79. Minister of Planning 1979-81. State Secretary, Ministry of Finance 1957-62. Secretary General, EFTA 1981-

87. Chairman of the committee responsible for “Penger og kreditt i en omstillingstid” (NOU 1989:1). Interviewed at BI, Sandvika 22.05.1992.

Borger A. Lenth. President, Kreditkassen 1991-1996. Executive vice-president, DnC 1976-82. Interviewed at Kreditkassen 09.06.1992.

Ivar Leveraas. Managing Director, Husbanken 1985-97. Secretary General of the Labour Party 1975-85. Interviewed in Husbanken 12.06.1992.

Per Meinich. Professor of Economics, University of Oslo. Chairman of the Meinich-committee on Finance houses 1969-74. Consultant to Norges Bank in the 1970s. Interviewed at Blindern, University of Oslo 09.06.1992.

Per Melsom. Advisor, Storebrand. Inspector at Bankinspeksjonen 1960-70. Ministry of Finance 1970-80. Director at Bankinspeksjonen 1980-86. Attached to Bankinspeksjonen until 1993. Interviewed at Storebrand, Oslo 04.03 1998.

Tor Moursund. President, Kreditkassen 1977-89. Chairman, Kreditkassen 1990-91. Chairman, Norwegian Bankers Association (1978-80). Interviewed at BI, Sandvika 16.06.1992.

Bjarne Orten. Managing Director, Husbanken 1974-87. Held various positions, Husbanken 1948-87. Interviewed in Oslo 27.05.1992.

Trond Reinertsen. Managing Director, the Norwegian Bankers Association 1980-98. Various positions at the Ministry of Finance 1975-1980. Interviewed at Norwegian Bankers Association 27.05.1992.

Sverre Walter Rostoft. President, Kreditkassen 1990-1991. Executive vice-president, Kreditkassen 1980-90. Executive director of Norwegian Bankers Association 1976-80. Interviewed at “Innovation A/S” 26.05.1992.

Ulf Sand. Secretary General, Ministry of Local Government and Regional Development. Minister of Finance 1979-81. Member of “Renteutvalget” 1978-79. Interviewed at the Ministry of Local Government and Regional Development 04.06.1992.

Hermod Skånland. Governor, Norges Bank 1985-93. Vice-governor, Norges Bank 1971-85. Interviewed at Norges Bank 18.06 1992, 03.12.1999 and 09.02.2000

Ole Gabriel Ueland. Member of Parliament since 1977. Member of the Standing committee on finance of the Storting 1981-85. Interviewed at the Storting 15.06.1992.

Kåre Willoch. Prime Minister 1981-86. Minister of trade 1965-70. Member of Parliament 1958-89. Chief administrative officer of Oslo and Akershus counties (1989-1998). Interviewed at the Chief administrative officer’s office 05.06.1992.

Svein Aasmundstad. Managing Director, Kredittilsynet 1987-1992. Interviewed at the University of Oslo 05.03.1998

Sources and references

Sources

I have used three different types of source in this work. Interviews, official documents and publications, and academic literature. The academic literature is listed below under references. The interviewees are listed in appendix II. References to specific interviews are footnoted. As a rule, the official documents used are listed in the footnotes only. This includes The Proceedings of the Storting (*Stortingsforhandlingene*). These publications cover all debates held in the Norwegian parliament and they are referred to as *St.forh.* in the footnotes. “White papers” or Reports to the Storting (*Stortingsmeldinger*), including the state budget, are referred to in the footnotes as *St. Meld.* References to newspaper clippings are also footnoted.

Two types of official document are actually listed in the reference list. These are Norwegian official reports (Norges Offentlige Utredninger/the NOU-series) and submissions from *Norges Bank*. The NOU-series has a book-like format and all the submissions from Norges Bank quoted here are printed in the Central Bank’s quarterly journal *Penger og kreditt* (“Economic Bulletin”). The submissions and some other documents from *Norges Bank* are depersonalised. When I have quoted these I have therefore listed Norges Bank (without italics) as the author. When quoting from these submissions I have, when possible, used the English translation made available by Norges Bank on the Web, while the page numbers given refer to the Norwegian text version I have had access to through *Penger og kreditt*. This information is also given in the relevant footnotes.

I have not used many Web-resources. The main concern as regards use of the Web is that it shall be impossible for readers to trace the sources listed. I have therefore only taken Web-based information from conservative and well-established institutions, namely the International Monetary Fund (IMF) and *Norges Bank*. The

documents I have quoted or taken statistics from also exist in printed versions, but the Web-versions were more easily accessible (and sometime published earlier).

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