

Norges Bank Watch 2026

An Independent Evaluation of Monetary Policy in Norway

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FOREWORD

Each year the Centre for Monetary Economics (CME) at the Department of Economics, BI Norwegian Business School, appoints an independent group of experts to evaluate monetary policy in Norway.

This year the NBW committee consists of Tore Grobæk Vamraak, Chief Economist at Sparebanken Norge, and myself, Tommy Sveen, Professor at BI Norwegian Business School. The NBW committee is solely responsible for the report and the views therein. The report does not necessarily represent the views of the CME or of its members.

The Ministry of Finance uses the Norges Bank Watch reports as input to their annual Financial Markets Report to the Parliament, when assessing the conduct of monetary policy. The Ministry of Finance partly funds the Norges Bank Watch reports.

Oslo, February 25, 2026

Centre for Monetary Economics

Tommy Sveen

NORGES BANK WATCH 2026 – EXECUTIVE SUMMARY

Entering 2025, Norway was one of the only countries still at post-pandemic peak policy rate. Norges Bank had expressed that the interest rate would “most likely be reduced in March 2025”. Just before the March committee meeting, several indicators showed surprisingly strong numbers for the Norwegian economy. Norges Bank adapted to the new information and kept the interest rate unchanged, as also the market actors gradually turned into supporting.

Before the June meeting, most economists expected Norges Bank to still keep the policy rate at 4.5 percent, as most economic indicators still witnessed a strong economy. The decision to cut the policy rate came as a surprise to the market. This raised discussion about the communication and predictability of Norges Bank’s monetary policy decisions. Norges Bank has afterwards made an effort to safeguard the strong trust in its monetary policy.

In September, Norges Bank was in doubt whether to cut or keep the policy rate. Norges Bank saw the need to tighten in the long run, still at the time saw the need to loosen for the shorter run. Norges Bank found a good way of balancing the two objectives, by reducing the policy rate and lifting the long-term rate curve.

In December, there was to expectation of a policy rate change. It was however now visible that after two interest rate cuts, the inflation had become stickier than Norges Bank had expected.

As high employment is an explicit monetary policy goal, we discuss the two different statistical indicators for unemployment: Registered unemployed (Nav) and Statistics Norway’ Labor force survey.

The long-lasting high interest rate has particularly hit the real estate and construction industry hard. The industry effects are not the responsibility of Norges Bank. However, Norges Bank’s predictions of the policy rate curve and the level of housing investments are both useful indicators for the responsible bodies and have been consistently predicted too optimistically.

To mitigate the risk of internal dominance and groupthink, we recommend expanding the Monetary Policy and Financial Stability Committee from five to seven or nine members, with a higher proportion of external experts. Furthermore, these external members should be provided with dedicated professional support to effectively challenge internal staff assessments. We do, however, welcome the recent decision to publish anonymized summaries of the Committee's discussions, as it enhances transparency.

We caution against interpreting the mandate for "high" employment as an overly ambitious output target. Norges Bank must clearly communicate that the primary contribution to long-term economic output is maintaining price stability, ensuring the inflation target remains a credible, hierarchical anchor.

We encourage Norges Bank to explicitly incorporate key financial stability variables—such as house price growth, household debt burden, and commercial real estate vulnerabilities—into its diagnostic GEORG policy rule.

1. Introduction

This report, Norges Bank Watch 2026, is an evaluation of the conduct and the communication of monetary policy in Norway in 2025. In addition, the report raises some policy issues for Norges Bank.

In section 2 we review and comment on Norges Bank's monetary policy in 2025. Most of the comments concern communication. In section 3 we raise some policy issues for Norges Bank. For example, we welcome the decision by Norges Bank to publish anonymized summaries of the Committee's discussions.

The committee met with the Ministry of Finance on October 28, 2025, and with Norges Bank on November 28, 2025. We wish to thank Norges Bank and the Ministry of Finance for constructive comments.

2. Monetary Policy and Communication in 2025

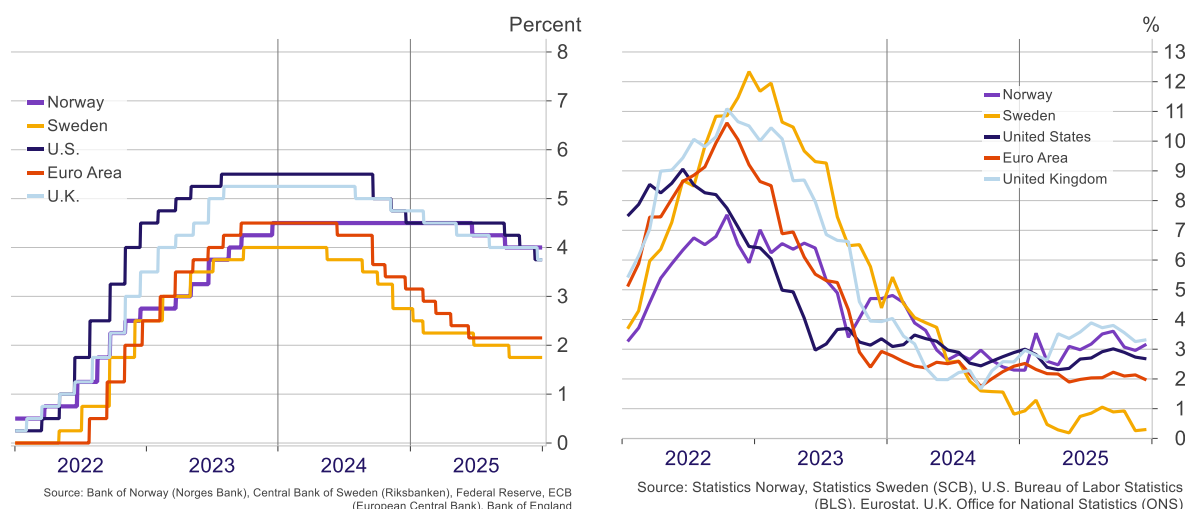
This chapter reviews the monetary policy environment at the start of 2025, the key policy decisions throughout the year, and their implications for the Norwegian economy.

2.1 The starting point

Entering 2025, the interest rate in Norway had diverted away from following the pattern of our major trading partners. Most central banks had close to zero interest rates during the covid-19 pandemic and rose the interest rates substantially throughout 2022 and 2023. The substantial monetary policy tightening cooled down most economies enough to allow for several interest rate cuts during 2024.

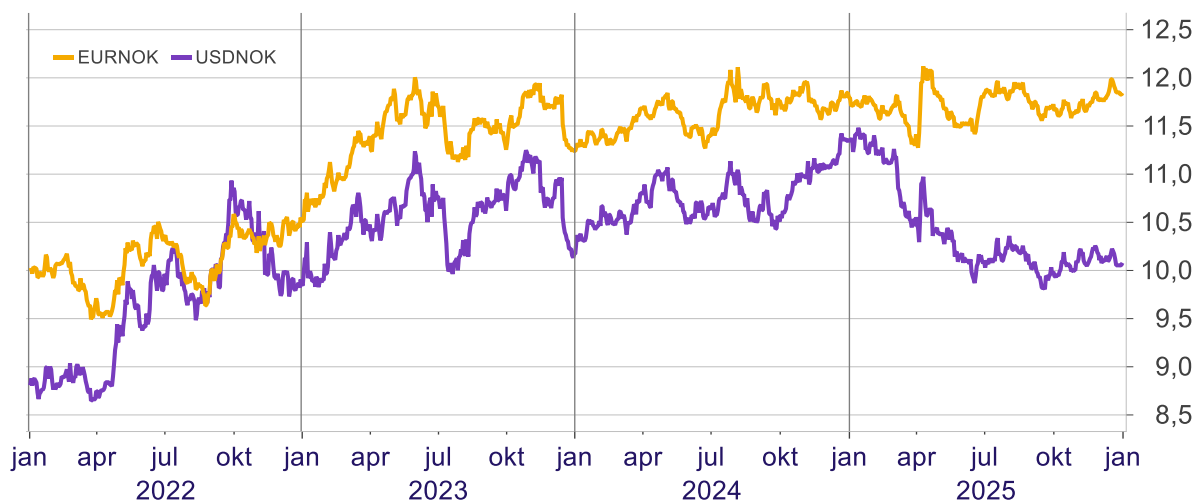
In Norway, by contrast, inflation remained elevated, and Norges Bank kept the interest rate unchanged at 4.5 percent throughout 2024.

Chart 2.1 The graph reports the policy rates from Norway and our most important trading partners, and the inflation figures from the same economies.



The Norwegian krone had gone through a substantial weakening both in 2024 and previous years, compared to both euro and US dollars. The weakened currency has contributed to the high inflation level in the Norwegian economy these years.

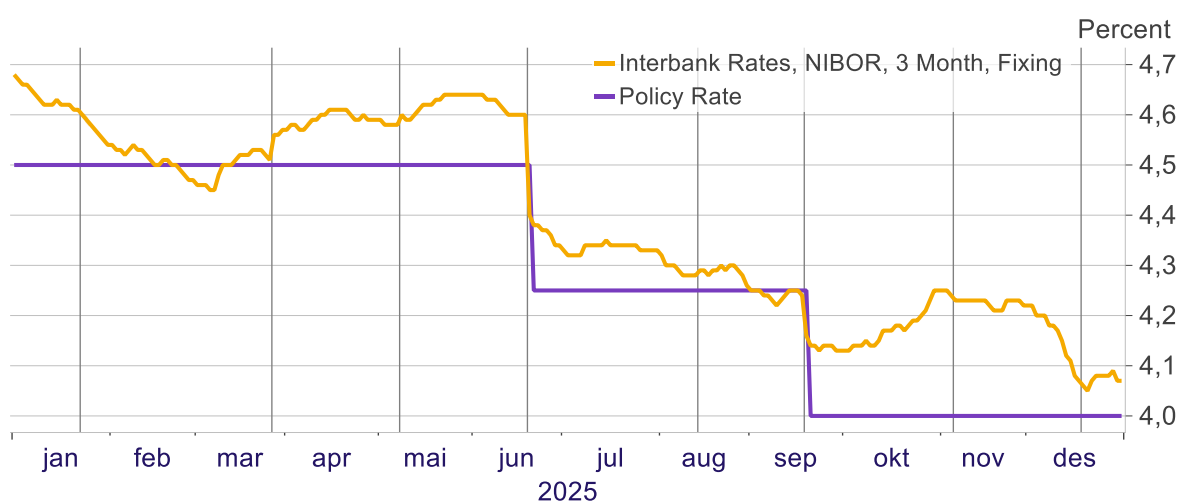
Chart 2.2 After several years of depreciation towards EUR, the NOK has maintained its strength throughout 2025. The NOK has strengthened substantially towards USD in 2025.



2.2 Development and execution

In 2025, Norges Bank made two policy rate cuts, in June and September. We will walk through each of the major monetary policy meetings, i.e. at the end of the quarter, when the Monetary Policy Report is published. In times without rapid movement in the policy rate, Norges Bank has a tradition for making policy rate changes only in these meetings. Then they can communicate a full picture of their assessments leading to the policy rate change.

Chart 2.3 The NIBOR interbank rate dropped almost 0.25 percentage points in June, indicating an unexpected policy rate cut. The NIBOR rate movements in September indicate increased market uncertainty, with a market bias toward expecting a policy rate cut.



March meeting

Ahead of the March meeting, Norges Bank signaled a likely rate cut. In December 2024, Norges Bank stated that “Based on the Committee’s current assessment of the outlook, the policy rate will most likely be reduced in March 2025”. The first press conference in 2025, on January 23rd, had the headline “Policy rate will likely be reduced in March”.

During the last two weeks leading up to the March committee meeting, several indicators showed surprisingly strong Norwegian economy: CPI numbers jumped up, Norges Bank Regional Network show strong optimism throughout the economy, and the unemployment rate remained low. With these facts, more and more market actors turned away from their strong belief in an interest rate cut. We commend Norges Bank for having placed greater emphasis on the new information, rather than sticking to its recent predictions for a March cut, keeping the policy rate unchanged in March.

The strong signals from Norges Bank in December 2024 and January 2025 pointing towards a likely policy rate cut in March were falsely interpreted by several market actors as a “promise” for a rate cut. Obviously, the central bank does not promise the future policy rate. However, the projections upfront could have been better understood if it was accompanied by a probability distribution.

June meeting

The market and most economists expected Norges Bank to keep the policy rate at 4.5 percent in June, as most economic indicators still witnessed a strong economy. The decision to cut the policy rate from 4.5 to 4.25 percent came as a surprise to the market.

Norges Bank had in its most recent Monetary Policy Report from March indicated that the first cut would be in September. The economic indicators were in June mostly as expected in the March report. The press release from the May meeting gave no indication of a soon-to-come policy rate cut.

The decision to cut the interest rate in June raised discussion about communication and predictability of Norges Bank’s monetary policy decisions. As one chief economist said, “I will emphasize the guiding from Norges Bank less in the future.” The governor addressed this issue herself at the press conference after the next meeting in August: “Norges Bank does not like surprising the market”. She also underlined that “very precise signals on our near-future decisions can be given too much weight and can be perceived too much as a promise,” giving a hint that the market actors have misunderstood the central bank’s communication.

The unexpected policy rate cut raised questions about the trust in Norges Bank’s monetary policy. However, the trust in Norges Bank is still strong, and Norges Bank’s handling of the event afterwards has strengthened the trust. The challenge of precise signals could be managed by introducing a probability distribution for the policy rate curve.

September meeting

A majority of the chief economists had low expectations of a September cut in advance, and meant that it would be too soon to cut the policy rate. The market gave however a ca 60 % probability for policy rate cut, implied from the NIBOR forward curve.

Norges Bank underlined at the press conference that they had seriously discussed both cutting and keeping the policy rate. From the economic indicators at the time, one could argue both ways. We value the balanced view of Norges Bank, clearly stating the doubt.

Norges Bank expressed concern about the inflation. In hindsight it is tempting to conclude that Norges Bank underestimated how strong the inflation had become. The governor presented a chart with the title “The pace of disinflation has slowed”, showing a graph with CPI growth steadily increasing to a new pinnacle, and CPI-ATE growth having stabilized at a too high level. The data indicated that the inflation had taken hold, but Norges Bank concluded that a rate cut would be beneficial for the short-term.

Norges Bank found a good way of balancing short-term and longer-term considerations: The policy rate was cut from 4.25 to 4.0 percent, but the long-term rate curve was lifted to a higher level. This decision satisfied both the assumed need to stimulate the economy in the short term and the need to keep the economy from heating in the longer term.

December meeting

In line with the expectations set out in the Monetary Policy Report from September, there was no expectation of a policy rate change in December. Hardly any of the chief economists expected a rate change. They pointed out that the inflation had become stickier and higher than Norges Bank expected in the September MPR.

Norges Bank now addressed the concern about inflation in a much stronger wording. The title was now “Inflation has not declined further over the past year”. That indicates a recognition of stickier-than-expected inflation.

2.3 Level of unemployment

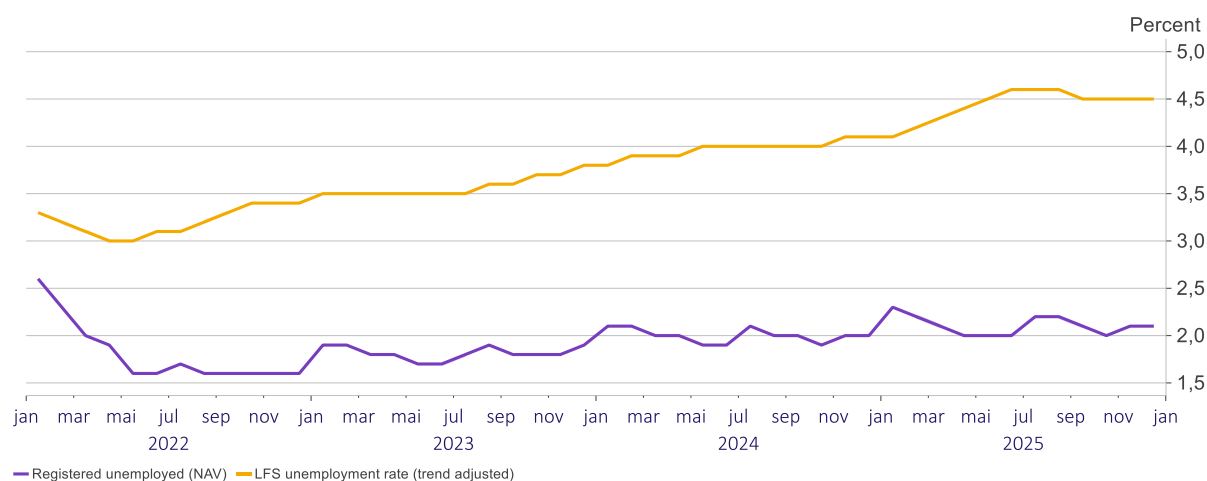
The task of monetary policy is to ensure low and stable inflation *and to help keep employment as high as possible*. It is therefore important for the execution of the monetary policy that all actors in the market have a common and well-informed understanding of the unemployment level. As mentioned in NBW 2025, the revision of the Monetary policy strategy included an underlining of that considerable weight shall be given to employment – also at times when inflation deviates significantly from the target.

Is the unemployment level currently at a stable, low level or at a rising path to an alarmingly high level? The answer will depend on which indicator we use.

The register based Nav statistics shows small variations between 2.0 and 2.3 percent in 2025, and variations between 1.6 and 2.3 percent since the summer of 2022.

Statistics Norway's Labor force survey, by contrast, has in the same period since the summer of 2022 increased steadily from 3.0 to 4.5 percent.

Chart 2.4 Unemployment



The main reason for different patterns in the Nav statistics and Statistics Norway Labor force survey (LFS) is an increase of unemployment amongst students and newly arrived immigrants. None of these groups have earned rights to unemployment benefits and are therefore not present in the Nav statistics.

Both statistics are relevant, but when considering the temperature of the economy we would argue that individuals with a strong connection to the labor market are more relevant than people without a present or recent connection to the Norwegian labor market.

2.4 Industries affected by the policy rate level

We have seen a strong demand from several industries in 2025 and the previous years: Export industries have benefited from the recent years' weakening of the NOK. The petroleum industry and the substantial supplier industry have benefited from the generous temporary petroleum tax package introduced in 2020 and years with high oil prices. Government funded industries have also been fuelled by substantially increased spending from the oil fund.

The strong demand from these sectors has caused a longer period of high interest rates in Norway than expected, and a longer period than any comparable economy. No major industry has been harder hit than the real estate and construction sector. The very low activity level has impact outside the industry itself. Several years of all-time low housing construction can contribute to instability in the housing market.

In the current monetary policy review, several hearing bodies have pointed at the current situation in the construction sector and advocated for Norges Bank to take industry effect and sectorial imbalances into account in the monetary policy.

The industry effects of the high interest rate are not the responsibility of Norges Bank. The government and the Parliament are responsible for accounting for effects on single industries. It has, however, been difficult to make the best decisions because of consistent prediction errors for two different parameters: the policy rate curve and the level of the housing investments. Both predictions have been too optimistic, from the construction industry's point of view. It is reasonable to believe that the negative effects for the real estate and construction sector have been even stronger because of the prediction errors. This underlines the importance of good forecasting from Norges Bank to the real economy.

2.5 Summary and overall impression

During 2025, Norges Bank held 8 monetary policy meetings, and cut the policy rate twice. Norges Bank surprised the market in June, with a totally unexpected policy rate cut that raised questions among market participants about the predictability of Norges Bank's communication. Both in March and September, Norges Bank has maneuvered challenging macroeconomic terrains wisely.

3. Policy Issues for Norges Bank

In this section, we consider policy issues for Norges Bank. We start by discussing the Committee for Monetary Policy and Financial Stability, which has been a recurrent topic in Norges Bank Watch (NBW) reports over several years. Then we raise some issues regarding the current assessment of the monetary policy regulation, and we discuss monetary and fiscal coordination. Last, we discuss an important point raised by Espen Henriksen, namely the extent to which the central bank should have the responsibility of exchange rate stabilization.

3.1 The Committee for Monetary Policy and Financial Stability

In recent years, the Norges Bank Watch reports have consistently scrutinized the composition and size of the Monetary Policy and Financial Stability Committee. We would like to echo some of the earlier concerns.

Since its formal establishment in 2020, the Committee has consisted of five members: the Governor, the two Deputy Governors, and two external members appointed by the King in Council. NBW has frequently pointed out that this structure is an outlier by international standards, where monetary policy bodies are typically larger and feature a stronger representation of external experts.

A primary concern raised in these reports is the risk of **internal dominance**. Because the three internal members constitute a majority, they theoretically possess the power to pass any decision without the support of the external members. The reports express concern that this imbalance may weaken “the critical challenge function” necessary for complex decision-making. This asymmetry is further exacerbated by the fact that internal members have daily access to the Bank’s extensive staff resources and analytical tools, while the two external members must process vast amounts of technical data with limited independent support. To mitigate this, NBW has suggested that external members should be provided with dedicated professional support or specific resources to more effectively challenge the internal view. In her annual speech this year (2026), the Governor said that the Committee has always managed to make unanimous decisions. This is remarkable given the extent to which economists seem to disagree about all other topics.

Regarding the **size of the Committee**, NBW has argued that five members are too few to ensure sufficient cognitive diversity. Expanding the Committee to seven or nine members has been highlighted as a potential solution to incorporate a broader range of perspectives and reduce the risk of “groupthink”. The reports suggest that a larger committee with a higher ratio of external members would not only strengthen independence but also foster more robust debates regarding the difficult trade-offs between inflation, employment, and economic stability. We agree with this view.

Finally, NBW has linked the Committee's composition to its **communication practices**. By questioning the "one voice" policy—where the Committee presents a unified front—the reports imply that a change in structure, combined with the publication of voting records or dissenting views, would provide the public with better insight into the internal deliberations. Taken together, Norges Bank Watch portrays a committee that functions well operationally, but one that would benefit from being larger and more independent to meet future economic challenges and maintain high public trust in Norwegian monetary policy.

In the before-mentioned annual speech, the Governor announced that Norges Bank will start publishing a summary of the discussions in the committee. She underscored that minutes will still not be published and the summaries will omit the names of the committee members. We welcome the change. We think that this move will help providing the market with deeper insight into the breadth of arguments considered, revealing the balance of risks perceived by the policymakers without attributing specific views to individuals. While this falls short of the full attribution seen in some other central banks, it represents a significant shift away from the previous approach.

3.2 Trust, Time Inconsistency and Central Bank Independence

Economic history has established the consensus that monetary stability is a necessary precondition for sustainable economic growth. Stable prices allow businesses to invest, households to plan, and markets to allocate capital efficiently. Yet, despite this widespread understanding, there are many examples in history of policymakers abandoning long-term stability in favour of short-term gains.

The fundamental issue is a misalignment of incentives. Elected politicians operate within short electoral cycles and face strong pressure to deliver results. This creates a structural temptation to use monetary policy to engineer short-term economic booms. By protecting the monetary policy instrument from these pressures, society attempts to shield the economy from the "political business cycle".

This framework is best understood through the "time inconsistency problem", famously identified by Kydland and Prescott (1977). They demonstrated that even well-intentioned policymakers can potentially produce high average inflation if they possess the discretion to change their plans period-by-period. The logic unfolds as a game: a policymaker may promise low inflation to anchor expectations, but once wage contracts are signed, they face a temptation to create surprise inflation to lower real wages and boost employment.

However, rational economic agents anticipate this temptation. Knowing the government has an incentive to inflate, they set their wage demands high enough to protect themselves. The policymaker must then validate these expectations with high inflation just to prevent

unemployment from rising. The economy settles into a suboptimal equilibrium known as "inflation bias"—high inflation with no gain in output. To solve this, society must remove discretion and tie the policymaker's hands to a "commitment technology," such as an independent central bank.

3.2.1 The Loss Function and Inflation Bias

In modern central banking the central bank is typically modelled as an agent attempting to minimize a "loss function". This function represents the "cost" to society of deviations from the ideal economic state; the central bank aims to drive this value as close to zero as possible.

A standard quadratic loss function L_t is written as:

$$L_t = \frac{1}{2}[(\pi_t - \pi^*)^2 + \lambda(y_t - y_t^*)^2]$$

where π_t is some measure of the rate of inflation (e.g. the CPI inflation) and π^* is the inflation target. The variable y_t is log of GDP, while y_t^* is natural GDP. The two terms in bracket are typically referred to as the inflation gap and the output gap, respectively. Parameter λ is the relative weight placed on stabilizing the output gap versus stabilizing the inflation gap.

Barro and Gordon (1983) utilized this framework to explain time inconsistency mathematically. The starting point was a loss function similar to the one described above, but with a critical modification: the output goal of the policymaker was assumed to be higher than the natural level (y_t^*)—the policymaker targets a level of output κy_t^* , where $\kappa > 1$. This assumption reflects that governments may often view the "natural" rate of unemployment as inefficiently high and therefore want to push employment beyond its natural level.

In addition, the policy maker faces a constraint imposed by the expectation-augmented Phillips curve:

$$y_t = y_t^* + (\pi_t - \pi_t^e)$$

This equation indicates that output can only rise above the natural level if actual inflation exceeds expected inflation (π_t^e)—in other words, if the central bank creates a "surprise" inflation. If the public expects low inflation, the central bank has a strong incentive to "cheat". For by creating surprise inflation, they can temporarily boost output toward their ambitious target κy_t^* . However, economic agents (unions, firms, households) understand the policymaker's incentive to stimulate the economy. They know that if they set low wage demands, the policymaker will inflate away their real wages. Consequently, the public raises their inflation expectations before the policy is enacted. They raise expectations exactly to the point where the marginal benefit to the policymaker of inflating further equals the marginal cost of higher inflation. The result is an inflation bias. The economy settles at an equilibrium

with high inflation but no gain in output. Because π_t ends up equaling π_t^e , output remains at the natural level y_t^* .

This elegant model shows mathematically that discretionary policy, when combined with a desire to target output above potential, results in too high inflation. This is why the "output target" in the loss function must be treated with caution, and why credible commitment devices are necessary to anchor expectations.

Let us remind ourselves about the economic costs of inflation. These costs are primarily linked to allocative inefficiency and distributional distortions. While the traditional frictions of holding physical cash are largely obsolete in highly digitized economies like Norway, inflation still imposes significant burdens. Nominal rigidities lead to staggered price setting, which distort relative prices across the economy. Furthermore, unanticipated inflation generates arbitrary wealth transfers from creditors to debtors and elevates macroeconomic uncertainty. This heightened uncertainty embeds risk premia into long-term interest rates, which ultimately dampens investment.

3.2.2 The Mandate Debate

This theoretical background is essential for evaluating the governance of Norges Bank. The current Regulation on Monetary Policy (2018) states that policy shall "contribute to high and stable output and employment". While "stable" output is standard, the inclusion of "high" is controversial. It risks implying a target of $\kappa > 1$, potentially reintroducing the very inflation bias that central bank independence was designed to eliminate.

Recent evaluations, such as the Norges Bank Watch 2024 report, have warned of "asymmetric" policy preferences, where the bank might be perceived as aggressive in stopping unemployment from rising but less energetic in preventing it from falling too low. If the market believes the bank fears unemployment more than inflation, the nominal anchor could weaken, increasing the "sacrifice ratio" required to tame future inflation.

Norges Bank is not unique in having an employment goal, though. The Federal Reserve operates under a "dual mandate" with equal weight on maximum employment and price stability. The Reserve Bank of Australia is mandated to "contribute to the stability of the currency, full employment, and the economic prosperity and welfare of the Australian people" (Reserve Bank of Australia). This is done by setting "monetary policy to inflation in the economy to 2–3 per cent and employment at the maximum level that is consistent with maintaining low and stable inflation". Other institutions like the Bank of England and the ECB utilize a hierarchical mandate, where support for growth and employment is explicitly "subject to" maintaining price stability. The Norwegian mandate's phrasing is more open to interpretation than the hierarchical models, placing a heavier burden on the Committee to communicate that the main contribution to long-term high output is through price stability.

Despite the risks of a too ambitious output target, there are valid economic reasons for giving weight to the level of production and employment. The most compelling argument for this is "hysteresis". Hysteresis describes a dynamic where the natural rate of unemployment (NAIRU) is not static but adjusts to actual unemployment levels. Short-term demand shocks can result in permanent changes in employment as displaced workers suffer skill depreciation or lose motivation.

The Norges Bank Watch 2021 report highlighted this during the COVID-19 pandemic, concluding that aggressive rate cuts were justified precisely to prevent hysteresis. In this scenario, prioritizing the "output" term was not a result of inflation bias, but a rational response to avoid permanent degradation of the workforce.

3.2.3 Credibility as the Prerequisite

While the loss function provides an elegant framework for flexible targeting, it conceals a theoretical weakness: it takes credibility for granted. The model treats the inflation target, π^* , as a fixed parameter, assuming economic agents believe it is the true anchor.

In the real world, π^* is a promise, not a physical constant. If the bank puts too much weight on output (λ is too large), targets unsustainable employment ($\kappa > 1$), or puts weight on too many other targets, the public may conclude that π^* is not an important target. Once this belief shifts, inflation expectations might unmoor.

Therefore, the hierarchy between inflation and real economic activity remains essential, we think. Monetary policy can only effectively support high output if the public believes the central bank will inevitably bring inflation back to target. The ability to practice flexible targeting—to "lean against the wind" or prevent hysteresis—is borrowed from the credibility of the inflation target.

3.3 Monetary policy and financial stability

We start this subsection by setting up a very simple toy model from Røisland and Sveen (2018) (see Norges Bank Watch 2021). The model consists of two main equations describing aggregate demand and inflation in addition to the loss function (see above). Aggregate demand is given by:

$$x = -\alpha_1(r - \rho) + \alpha_2 e + \chi q + v \quad (1)$$

where $x = y - y^*$ is the output gap, $r = i - \pi^e$ is the real interest rate—the nominal interest rate, i , minus expected inflation, π^e . There are two financial variables in the model, the real exchange rate, e , and a financial variable q . Both are measured as deviation from trend levels. We will refer to the latter as (excess) credit. Last, we have the demand shock, v . The parameters are all positive and they measure how much changes in real interest rates, real exchange rates and credit affects aggregate demand.

The equation builds on the simple intuition that aggregate demand contracts when the real interest rate rises. This occurs because higher borrowing costs reduce the profitability of investment projects and dampen consumption as households either choose to save more or will spend more on increased debt service payments. Beyond interest rates, a higher real exchange rate—signifying a real depreciation—stimulates demand by making domestic goods more price-competitive, while expanded credit access further bolsters spending by easing financing constraints for households and firms.

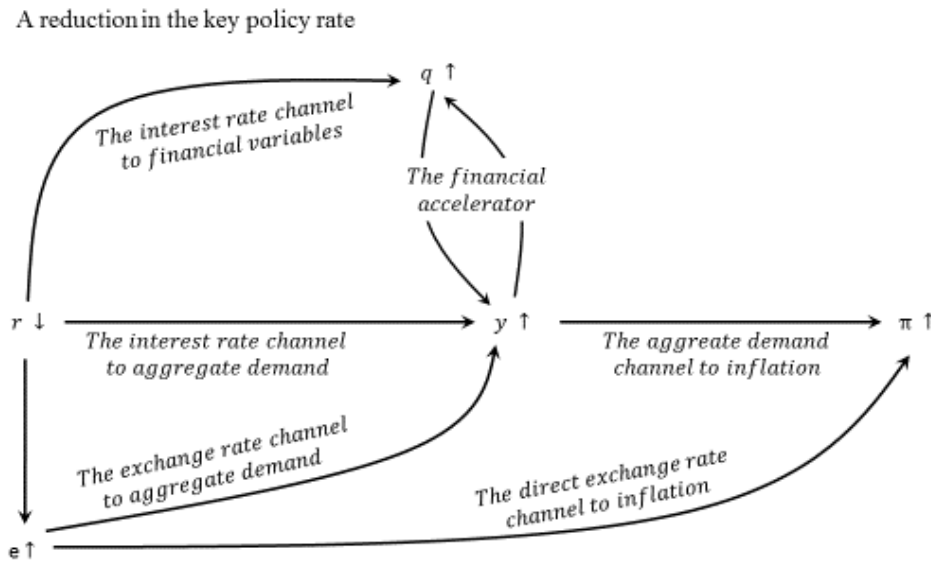
The real exchange rate and the financial gap are both linked to the real interest rate (see Røisland and Sveen 2018). Therefore, we can write the output gap as a reduced-form function of the real interest rate as follows:

$$x = -\frac{\alpha_1 + \alpha_2 + \phi\chi}{1 - \chi\tau}(r - \bar{r}), \quad (2)$$

where parameters ϕ and τ measure the extent to which the financial gap variable changes as the output gap and the real interest rate change, respectively. Moreover $\bar{r}$ is the neutral real interest rate, that is the real interest rate which closes the output gap. The equation's numerator identifies the three primary channels of monetary policy—interest rates, exchange rates, and credit access—each of which directly influences aggregate demand. Conversely, the denominator represents the financial accelerator, which captures the feedback loop between economic activity and asset values. In this process, rising demand boosts asset prices and collateral values, further easing borrowing constraints and amplifying the initial increase in demand.

The last equation links the rate of inflation to real economic activity in the standard way. An increase in real activity and a real depreciation will increase inflation. It might also be argued that changes in the financial gap variable should influence the rate of inflation. The idea would be that an increase in the financial wedge between constrained and unconstrained agents would increase the cost of cash credit. Chart 3.1 illustrates the transmission mechanism of monetary policy within this model.

Chart 3.1 Monetary policy transmission mechanisms



To complete the model, we need a description of monetary policy. We assume that policy is set in such a way that the following loss function is minimized, see, Røisland and Sveen (2018):

$$L = \frac{1}{2} [(\pi - \pi^*)^2 + \lambda x^2 + \omega q^2], \quad (3)$$

where π^* is the inflation target, and parameters λ and ω are the relative weights on stabilizing the output gap and the financial gap, respectively. Minimizing the loss function implies a targeting rule:

$$\pi - \pi^* = -\frac{\lambda}{\Xi} x - \frac{\omega}{\Theta} q \quad (4)$$

where parameters Ξ and Θ measure how easy it is to control the rate of inflation (relative to the output gap and credit, respectively) using monetary policy.

The central bank's primary objective is to ensure balanced development across the three fundamental gaps: the inflation gap, the output gap, and the financial gap. By stabilizing these variables, the bank seeks to align actual economic performance with its potential, keeping inflation near the target while mitigating financial imbalances that could threaten long-term stability.

Although many macroeconomic models treat "leaning against the wind" as a symmetric policy rule, there are good reasons for an asymmetric approach. Norges Bank's 2018 mandate explicitly requires the institution to "counteract the build-up of financial

imbalances". An important reason for this is that financial cycles are inherently non-linear. The handbook highlights the phenomenon where "credit bites back," noting that while financial crises are rare events, debt-driven upturns are associated with unusually deep and persistent recessions. Because financial vulnerabilities build up gradually over many years but unwind violently and rapidly, treating the boom and the bust symmetrically in a policy rule ignores the fundamental asymmetry of the financial cycle itself. An asymmetric policy acknowledges that it is incredibly difficult to gently deflate a credit bubble with interest rates, but important to react aggressively when that bubble bursts to prevent a severe economic contraction.

A symmetric approach also fails to properly weigh the macroeconomic costs. The handbook explicitly addresses the lack of consensus on LATW, noting that systematically keeping the policy rate higher to curb imbalances, reduces output and inflation more than would normally be implied by the central bank's standard response pattern. Critics have argued (a debate acknowledged in the handbook) that the costs of leaning symmetrically during a boom can be large: it risks driving average inflation below target and de-anchoring inflation expectations. Therefore, the threshold for raising rates solely to combat financial imbalances should be much higher than the threshold for cutting rates to mitigate the fallout of a financial shock, justifying an asymmetric stance.

Finally, the handbook reinforces that macroprudential tools—such as countercyclical capital buffers and mortgage limits—should act as the first line of defence against financial imbalances. Relying on the policy rate to symmetrically lean against asset prices is inefficient because it is a blunt instrument that affects the entire economy. Moreover, monetary policy creates a timing mismatch: while expansionary settings lower immediate economic risks, they simultaneously encourage the build-up of medium-term financial vulnerabilities.

It is not clear how important are financial stability considerations quantitatively, though. In Monetary Policy Report 4/2025, Norges Bank employs a simple, linear policy rule as a diagnostic tool to enhance the transparency of its decision-making process. This rule acts as a bridge between new economic data and the resulting adjustments to the policy rate path, allowing the bank to systematically decompose revisions since the former report. By quantifying how specific variables—inflation, capacity utilization, foreign interest rates, and the krone exchange rate—diverge from previous projections, the bank can illustrate the proportional impact each factor has on the Committee's forward-looking trajectory. The rule is named GEORG (Ganske Enkel Optimal ReGel) and is given by:

$$r_t = \bar{r}_t + \omega_r(r_{t-1} - \bar{r}_t) + (1 - \omega_r)\chi_t + z_t \quad (5)$$

The first term is the long-term policy rate, and the second term is linked to interest rate smoothing. The third term relates the policy rate to economic variables, where χ_t is a weighted average of key macroeconomic variables. What is somewhat surprising is that there

are no financial-stability variables on the list. We encourage Norges Bank to include the financial variables—for example household debt burden and bank losses—to GEORG. These are variables we know from the biannual financial stability report.

3.4 Fiscal and Monetary Policy Coordination

In the aftermath of the global inflation surge following the COVID-19 pandemic, there seemingly was a strong consensus among international economic organizations regarding macroeconomic stabilization. Institutions such as the IMF and the OECD largely advocated for a coordinated contractionary approach, advising that fiscal policy should align with monetary policy to curb aggregate demand. The prevailing view posits that divergent policies—specifically, fiscal expansion during a period of monetary tightening—undermine the central bank's efforts to control inflation, leading to higher interest rates and prolonged instability.

However, Røisland, Sveen, and Torvik (2023), in their Norges Bank Staff Memo 16/2023, provide a critical re-evaluation of this consensus within the specific context of a small open economy. The authors argue that the "coordinated tightening" prescription is derived largely from models applicable to large, closed economies. When applied to a small open economy like Norway, this standard advice may be suboptimal.

The authors analyse the interplay between monetary and fiscal policy. They demonstrate that the optimal policy mix depends on the nature of the economic shock. While demand shocks may justify the standard coordinated response, supply-side and exchange rate shocks frequently require a divergent approach—specifically, a combination of aggressive monetary contraction and counter-cyclical fiscal expansion.

3.4.1 Theoretical Framework

To evaluate the efficacy of policy coordination, it is necessary to distinguish between the transmission mechanisms available to policymakers in closed versus open economies. The divergence in optimal policy recommendations stems fundamentally from the structural differences in how these economies react to interest rate and fiscal adjustments.

In large, closed economies, external trade plays a minor role in price formation. Consequently, policymakers rely on a single primary transmission channel: Aggregate Demand.

- **Monetary Policy:** Higher interest rates raise the cost of capital, reducing consumption and investment.
- **Fiscal Policy:** Reduced government spending or higher taxes lowers public and private consumption.

In this framework, both instruments influence inflation by changing aggregate demand—by affecting the output gap. The two policy instruments are effectively substitutes. If fiscal policy expands while monetary policy contracts, the two instruments directly neutralize one another. Therefore, the standard advice for coordination is theoretically sound for closed economies; fiscal consolidation reduces the burden on the central bank.

In a small open economy like Norway, however, the central bank commands a second, distinct transmission mechanism: the exchange rate channel. While the demand channel operates identically to the closed economy model, the exchange rate channel offers a unique lever. An increase in the policy rate relative to foreign rates implies a currency appreciation. This appreciation directly reduces the price of imported goods and services, influencing CPI inflation independently of domestic demand conditions.

There will therefore exist an asymmetry in small, open economies regarding how the two policy instruments interact with these channels. Monetary policy impacts both demand and the exchange rate, allowing for disinflation without requiring the same degree of demand reduction as in a closed economy. By contrast, fiscal policy operates almost exclusively through the domestic demand channel. This asymmetry establishes a theory of comparative advantage for policy assignment: monetary policy is best suited for targeting inflation via the exchange rate, while fiscal policy is best suited for stabilizing real output via domestic demand.

3.4.2 Optimal Policy Responses

The authors develop a taxonomy of optimal policy responses based on the origin of the economic shock. The analysis distinguishes between demand shocks, cost-push shocks, and exchange rate shocks to determine the most effective mix of instruments.

A demand shock, characterized by a simultaneous surge in aggregate consumption and investment, presents the most straightforward scenario for policymakers. In this environment, high inflation coincides with a positive output gap, indicating that the economy is overheating. Consequently, the optimal response is a strategy of coordinated tightening. Both the monetary and fiscal authorities must act to restrict aggregate demand; the central bank by raising rates and the government by reducing spending. Since both inflation and real economic activity are deviating in the same direction, policy goals are perfectly aligned. Fiscal contraction in this context supports the central bank by dampening inflationary pressures, thereby reducing the need for excessive interest rate hikes and preventing the crowding out of private investment. In this specific scenario, the Staff Memo aligns with the general consensus.

The policy calculation becomes significantly more complex when the economy faces a supply-side or cost-push shock, such as a spike in global energy prices or supply chain disruptions. These shocks create a difficult trade-off where inflation rises while real economic activity contracts. The authors argue that a coordinated tightening in this scenario is inefficient, resulting in significant GDP loss for every unit of disinflation. Instead, the optimal strategy is a divergent policy mix. The monetary authority should pursue aggressive rate hikes to

appreciate the currency (or prevent depreciation) and curb imported inflation. Simultaneously, the fiscal authority should implement expansionary measures to support real income and employment. By allowing the instruments to move in opposite directions, the government can mitigate the contractionary impact of high interest rates on the real economy, effectively utilizing the exchange rate channel for price stability and the demand channel for employment stability. A similar logic applies to exchange rate shocks, where an exogenous depreciation of the currency drives up imported inflation. To maintain credibility and defend the nominal anchor, the central bank is compelled to raise interest rates. However, to prevent this defensive monetary policy from triggering an unnecessary recession, fiscal policy should provide counter-cyclical support.

Bergholt, Røisland, Sveen and Torvik (2025) formalize, expand, and refine the findings of Røisland, Sveen and Torvik (2023). Interestingly, the analysis is extended to include automatic stabilizers. The authors find that the role of these stabilizers mirrors the logic of discretionary policy. In the face of demand shocks, automatic stabilizers work in harmony with monetary policy (both restricting demand). Conversely, during inflation and exchange rate shocks, automatic stabilizers naturally push against monetary policy—providing fiscal support while rates rise. The paper argues that strong automatic stabilizers can effectively substitute for the optimal discretionary fiscal policy described in the 2023 staff memo, reducing the need for active political intervention which is often plagued by implementation lags.

3.4.3 A Stackelberg Game

Next, we extend the analysis in Røisland, Sveen and Torvik (2023) to consider a set-up where the central bank act as a Stackelberg leader vis-à-vis the fiscal authorities. This is a classic setup in political economy, and we get a very specific situation that often leads to an unfortunate mix of high interest rates and high government spending.

In a Stackelberg game, the “Leader” moves first and commits to a policy. The “Follower” observes this move and responds optimally. The leader is the central bank. It sets the interest rate to minimize its loss function (typically more weighted towards inflation stability). It anticipates how the government will react. The fiscal authority or government, the follower, observes the interest rate and then sets the budget deficit to minimize its loss function (typically more weighted towards output/employment).

We assume that the economy works in a simple way. High interest rates cool the economy, while government spending stimulates it. When the central bank acts first (e.g., raises rates to fight inflation), the government knows that unemployment will rise. Since the government cares deeply about employment (often more than the central bank does), the optimal response is to stimulate the economy. The result will be that if the central bank hits the brakes, the government will hit the gas. The reason is simple. The government tries to "offset" the contractionary effect of the interest rate on the real economy to protect jobs. The central bank is also rational. It does not set interest rates in a vacuum but knows the government's reaction function. Because the central bank knows that its instrument will be partially blunted by the fiscal response, it compensates by being more aggressive. In equilibrium, the central bank sets rates higher than

it would if it cooperated with the government. And the Government runs a deficit to counteract the high rates.

The Stackelberg framework offers a useful lens for Norway's recent macroeconomic experience. Following recent inflation shocks, Norway experienced the model's predicted mix: tightening monetary policy alongside a relatively accommodative fiscal stance. As a weak krone exchange rate and global factors drove up inflation, Norges Bank raised policy rates. To ease the resulting cost-of-living pressures, the government increased fiscal spending—notably through electricity subsidies. Anticipating this fiscal impulse, Norges Bank kept rates higher for longer to offset the government's expansionary measures.

However, as the model suggests for a small open economy, this uncoordinated approach was not entirely inefficient. Norges Bank's higher rates helped support the krone and mitigate imported inflation, while the government's fiscal spending successfully kept domestic unemployment low despite contractionary monetary policy.

3.5 Exchange rate stabilization

The Norwegian krone is one of the most volatile currencies, both towards USD and EUR, in recent years. The volatility is a severe burden to the real economy, as it increases uncertainty for commercial decision-makers or, if a hedge is possible, significantly increases the cost of managing currency risk.

This aspect is not often addressed and may seem irrelevant to a central bank with a strict inflation target and no official view on the exchange rate level. Under the current flexible inflation-targeting regime, Norges Bank utilizes the policy rate primarily to stabilize inflation and domestic output. The exchange rate is viewed largely as a transmission mechanism rather than a variable to be controlled. Consequently, direct interventions in the foreign exchange market to smooth out fluctuations are exceedingly rare, traditionally reserved only for extreme situations where market liquidity completely dries up.

It is, however, highly relevant in the light of the ongoing review of the monetary policy regulation. Associate professor Espen Henriksen at BI Norwegian Business School has recommended a clarification of responsibility related to the NOK volatility (Henriksen 2025).

The Norwegian economy would benefit from a clear responsibility when it comes to analysis and potential implementation of possible steps to reduce the NOK volatility. It is currently unclear whether this is the responsibility of Norges Bank, the Ministry of Finance or nobody at all.

3.6 NBW view

To mitigate the risk of internal dominance and groupthink, we recommend expanding the Monetary Policy and Financial Stability Committee from five to seven or nine members, with a higher proportion of external experts. Furthermore, these external members should be provided with dedicated professional support to effectively challenge internal staff assessments. We do, however, welcome the recent decision to publish anonymized summaries of the Committee's discussions, as it enhances transparency

We caution against interpreting the mandate for "high" employment as an overly ambitious output target. Norges Bank must clearly communicate that the primary contribution to long-term economic output is maintaining price stability, ensuring the inflation target remains a credible, hierarchical anchor.

We encourage Norges Bank to explicitly incorporate key financial stability variables—such as house price growth, household debt burden, and commercial real estate vulnerabilities—into its diagnostic GEORG policy rule.

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