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A Monetary History in Five Parts

1.1 Introduction

In simplistic language monetary history deals with money, its different forms and uses over the course of history and the different institutions involved in producing it. The concept of money is, however, intrinsically connected with a society's payment system and its institutions. Irrespective of whether money predominantly circulates among the general public in the form of coins and bank notes, as was the case in the eighteenth and early nineteenth century, or, as is the case in modern societies of the twentieth and twenty-first century, of money mainly appearing in the form of bank deposits, a well-functioning payment system is always built on trust. Historically, the general public had to trust the issuer of coins, typically the sovereign, to preserve the value of his coins and restrain himself from debasement or clipping. Likewise the issuers of bank notes had to be trusted that they would restrain themselves from the temptation of letting the printing works run, such that the overissuing of bank notes led to the undermining of their value. Finally, as deposits in private banks gradually evolved to become the main component of modern societies' money stock, the general public would need to have a similar faith in the banks with whom they entrusted their funds, believing that the banks could be trusted as custodians of their deposits. We will in the following denote the sum of the general public holdings of coins, bank notes and bank deposits as 'broad money', and we will often refer to this as M2 or 'the money stock', as is common in the literature on monetary aggregates.

A monetary history of Norway over the past two centuries spans a period that starts dramatically with Norway leaving the union with Denmark in 1814. Norway's monetary system was in a chaotic state and had to be completely redesigned from scratch. In the following years Norway transited from a tight union with Denmark, without her own national institutions, to enter into a loose union with Sweden. All main national institutions of Norway – its parliament, central government departments, supreme court, national auditing and a bank of issue, Norges Bank, all separate from the similar Swedish institutions – were all established in the formative years 1814–1816. Norway's constitution stated that the power over the monetary system should reside with the parliament and not the king. Since the parliament met only every third year the task was delegated to a new institution, a national bank, Norges Bank, which has performed this task ever since. The birth of Norges Bank represented the first successful step out of the monetary chaos caused by the Napoleonic Wars. Norges Bank's Board of Representatives is still appointed by the Storting (the Norwegian parliament), and this represents a continuity from the embryonic bank of issue that was established in 1816 to today's monetary system and the role of Norges Bank as central bank. This book describes, in detail, the transition from the dramatic situation in 1814 when the young nation had to restore a dysfunctional monetary system after the Napoleonic Wars, in desperate need to regain trust in money as medium of exchange, unit of account and store of value, to today's well-functioning monetary system as we know it, and which has proven to be quite resilient also during the global financial crisis of the recent years.

Part I deals with the period before 1850, with a brief overview over the last century of the Dano-Norwegian union, the collapse of the union's monetary system after 1807 and its reconstruction during the first years after the end of the Napoleonic wars. The reconstruction process for the monetary system was neither linear nor smooth. Despite optimistically stated ambitions during the formative years of the new nation, 1814–1816, of a short resumption period for its new currency, the speciedaler, it would take more than twenty years before the *long promise* of convertibility at par was finally fulfilled in 1842.

Part II focuses on the rise of private deposit-taking banks. Money had so far predominantly taken the form of notes and coins, and Norges Bank, the monopolist bank of issue, was the dominant supplier of credit. After the successful reconstruction of the monetary system and its trust in society had been restored by the early 1840s, the second half of the nineteenth century up to the dawn of World War I was a period of rapid monetisation of the Norwegian economy. Despite the strong growth in deposit-taking banks the period is one of monetary stability, i.e. at least in normal times. But this is also a period where the monetary authorities occasionally met challenges and needed to cope with financial crises, notably in

1847–1848, 1857–1858, 1877–1878 and 1899–1905. During this period Norges Bank, the monopolist bank of issue, advanced from being *a* bank among other banks, for a long time *the* dominating one, to become the central in the banking system and a bank *for* the other banks, or in modern parlance, *a central bank*.

Part III zooms in on monetary developments in Norway during World War I and the following turbulent interwar years. This period is dominated by great instabilities, where for a long time it was envisioned that prewar monetary stability was to be restored. A strong monetary expansion during the war followed, and when the boom turned into bust right after the war, the resumption of the gold standard was in effect postponed until after a severe banking crisis had been dealt with. A rapid resumption to prewar gold parities followed, which in hindsight has been strongly criticised. The gold standard was eventually abandoned in 1931. Prewar visions were gradually replaced by modern views among economists regarding the virtues of active demand management, and control over the business cycle as a recipe of how to avoid turbulence of the type that characterised the markets in the 1920s and 1930s.

Part IV starts out with World War II, when Norway was under German occupation, and focuses on the political economy of the new regime in postwar Norway, with its emphasis on regulation and central planning, with elements of corporative institutions and financial repression as key instruments. The prevailing low interest rate regime in this period warranted the use of a host of different instruments over the years, including different forms of credit rationing, in order to manage aggregate demand and, in particular, to allocate real investments to their main areas of priority. Eventually, the breakdown of the international postwar Bretton Woods regime led to a period with new instabilities; inflation picked up and was reinforced by the oil price shocks in the 1970s. At the same time the tight regulation policies of financial markets gradually became less effective and in the early 1980s they were to a large extent circumvented, e.g. through the expansion of those days' shadow banks. A decade with no less than ten devaluations of the Norwegian currency, attempting to compensate for losses in the relative competitiveness of Norway's export sectors, ended in 1986. From 1986 onwards Norges Bank was delegated the responsibility to set interest rates with the explicit goal of stabilising the exchange rate.

Part V describes the *long return to monetary stability* after the nominal anchor was lost during the 1970s and early 1980s. Price stability, defined as low and stable inflation in line with that of Norway's trading partners, became the anchor for monetary policy. To implement this policy, both the monetary system and Norges Bank needed some significant overhauling as independent institutions. However, the circumstances were difficult as Norway was hit in 1986 by a big negative shock to terms of trade caused by falling oil prices, unemployment rates increased and there was a sharp drop in housing prices, following several years of booming housing prices after the deregulation of housing and credit markets in the early 1980s. In the years 1988–1993 Norway also experienced a severe banking crisis, with systemic proportions in 1991–1992. During the first half of the 1990s many countries had changed their monetary policy system to that of (flexible) inflation targeting. Inflation in Norway was brought under control and hovered around 2.5 per cent. Inflation targeting was in practice introduced in Norway in 1999, although the de jure formalisation of the new regime took place only in March 2001, in conjunction with a new operational framework for fiscal policy. However, if we interpret the transition to inflation targeting more broadly, in terms of changes in the framework of monetary stability, it transpires that the evolution that took place in the period was more gradual, and, in hindsight, we argue in this book that it was in fact the changes that took place in 1986 that should be seen as the defining moment for the return to monetary stability with Norges Bank again playing a central role as guardian.

Throughout this book we draw heavily on data made available from the Historical Monetary Statistics project at Norges Bank (hereafter denoted HMS Norges Bank). We are now able to provide perhaps the most complete picture ever of the historical monetary developments over two centuries in Norway, a small open economy, located in the northern periphery of Europe. Beyond providing data for the aggregate stock of money in 1819–2014, we possess a host of balance sheet data for the country's main money creating institutions, notably Norges Bank, which has exercised its monopoly privilege to issue bank notes since 1818 (and coins since 1962), and deposit-taking private banks, which entered the scene from the 1820s onwards. The historical database also contains data for output (gross domestic product [GDP] industrial production, terms of trade, balance of payments), prices (consumer, wholesale, freights, real estate, terms of trade), wages, interest rates and exchange rates over the two centuries covered by this book.[1]

[1] The Norges Bank HMS database on Historical Monetary Statistics is available at www.norges-bank.no/en/Statistics/Historical-monetary-statistics/. The database is documented in two books: Eitrheim, Klovland and Qvigstad (2004, 2007b). The data are updated annually and are frequently used in speeches and for research purposes.

Although this book draws heavily on monetary statistics, it is not a data study. When we in our approach 'follow' the money stock this is not an expression of the inherent data enthusiasm of the authors, but because this measure is the one best capturing the monetary history of Norway over two hundred years. This introductory chapter presents the main monetary developments in Norway across the span over two centuries, from the early nineteenth century to the early twenty-first century. These developments are closely linked with the division of this book into five parts. The main monetary developments of each of the five parts are illustrated and presented in brief, leaving contextual details and historical narratives to be explained and discussed in the relevant chapters of each part.

1.2 The Functions of Money

When writing a monetary history we are in need of a conceptual understanding of money. A rich literature exists on the theoretical foundation of money, in the past as well as today.[2] In the present study we start out from the traditional functional approach: money is an object or record capable of fulfilling the core functions of money. In short: Money is what money does.

In broad terms we can identify three core functions of money: as means of exchange, store of value and unit of account. From these functions and from intersections between them, a number of sub-functions can be derived, but we will for the present stick with the core approach. Two of the basic functions of money, as means of exchange and as store of value, are largely self-evident. For the former the fundamental criterion is universality, that something fulfils a function in a number of exchanges involving differing goods and people. The latter introduces a time dimension, the function that the proceeds from one exchange can be used without risk of deterioration at some unknown point of time in the future. The third function, as unit of account, might be in need of some further exploration. Beyond bookkeeping, the unit of account refers to the information value of money. A common monetary reference will reduce transaction costs, e.g. the information costs of taking into account various and competing ways of referring to value. A common unit of account will reduce these costs and enhance the usefulness of money. Moreover, money is obviously dynamic:

[2] See e.g. chapter 2 in Friedman and Schwartz (1982) for a general background on the use of money in a historical context. The classic contribution to monetary history is Milton Friedman and Anna S. Schwartz, *Monetary History of the United States 1867–1960* (Friedman and Schwartz, 1963); for the United Kingdom, see Capie and Webber (1985).

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as more and more people start using money, transaction costs continue to decline, thereby expanding the usefulness of money even further.

Between the three functions, a hierarchy exists. Ideally, money fulfils all three functions. Depreciating monetary values, however, erode the capability of fulfilment. Store of value is the first to suffer as those eager to preserve their purchasing power over time switch to other forms of assets believed to be more stable. Inflation does not need to be very high to have some negative impact on this function, but the higher the inflation, lesser the trust in money as a store of value. Persistent high inflation will erode the information value of money and the public will begin to use other, more stable standards for monetary reference. Consequently, transaction costs will increase. In the end, inflation can wipe away the most basic function, that of medium of exchange, when money is no longer universally accepted and the economy returns to barter. Money will then cease to be money.

1.3 Money: From Commodity Money to Notes to Bank Deposits

Money is, in essence, a common public good that enhances exchange, smooths the economy and contributes to welfare. Over time and across cultures, a variety of objects have served as money. The most durable of all commodity monies, coins of precious metals, most notably silver and gold, continued to play a monetary role until 1971. From the eighteenth century onwards, bank notes played an important role in the supply of money.

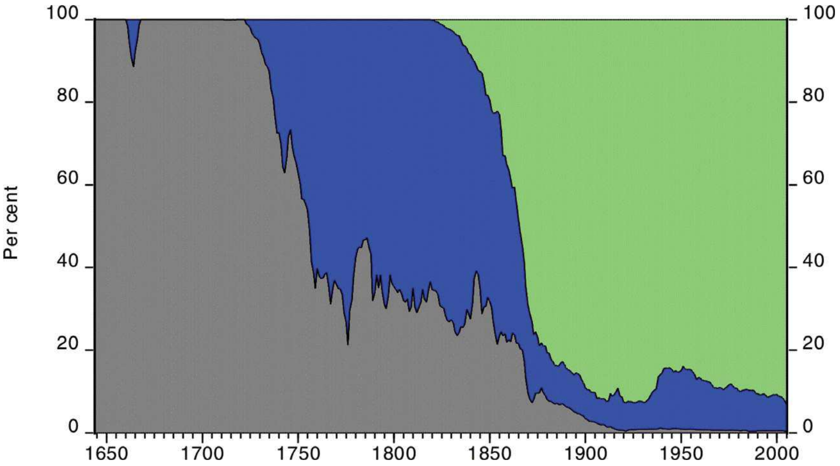

Figure 1.1 The composition of money: coins (grey), notes (blue) and bank deposits (green), measured as shares (in per cent) of broad money. Data for Sweden, 1644–2013.
Source: Sveriges Riksbank Historical Monetary and Financial Statistics.

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Although in relative decline, notes are still of some use, particularly in less advanced countries. In advanced countries, cost efficiency is hardly the quality that makes notes attractive, but rather their anonymous character. The lion's share of money today takes the form of bank deposits and related

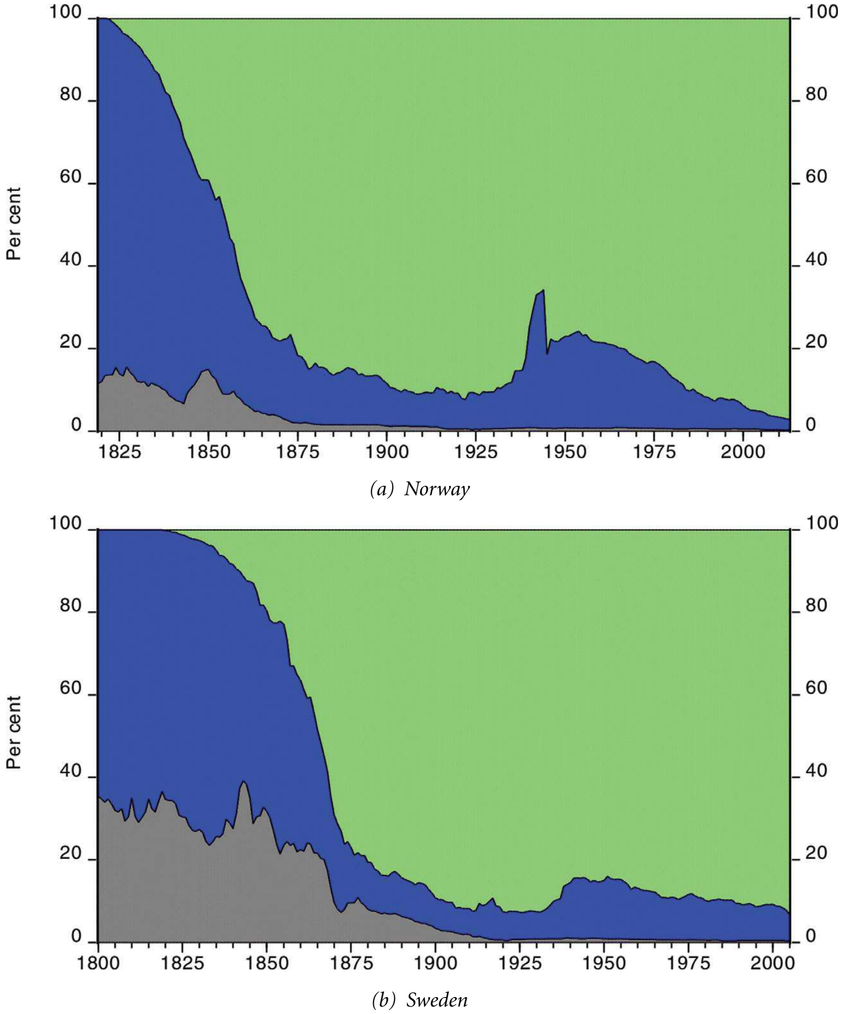
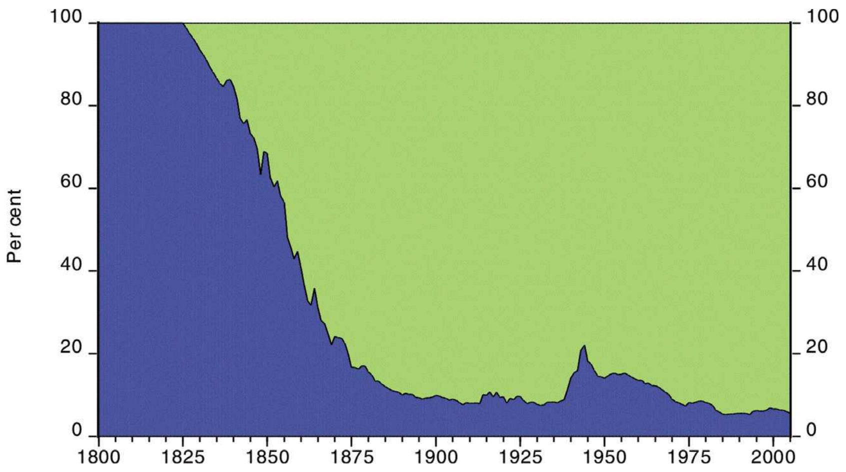


Figure 1.2 The composition of money: coins (grey), notes (blue) and bank deposits (green), measured as shares (in per cent) of broad money in three Scandinavian countries, 1800 onwards. Note that for Denmark we have data available only for total currency in circulation (notes plus coins).

Source: Norges Bank HMS, Swedish Riksbank HMS, Danish Monetary History (Svendsen et al., 1968) and (Abildgren, 2006)).



(c) Denmark

Figure 1.2 (Cont'd)

assets, a development that commenced with the breakthrough of deposit banking in the second half of the nineteenth century.

These broad lines of development are shown in Figure 1.1, which, admittedly, is based on data from the Swedish monetary history going back to the early 1600s when money was predominantly coins made of precious metals such as gold, silver and/or copper. We need data for the seventeenth and eighteenth century to capture the monetary transition from coins to bank notes. Sweden's long history allows us to describe both main transitions, first from coins to bank notes in the eighteenth century, second, from bank notes to bank deposits in the nineteenth century. In the three Scandinavian countries the latter transition took place during the midst of the nineteenth century; see Figure 1.2. The development of deposit-taking banks in Norway is discussed in detail in Part II.

1.4 Money Is Based on Trust

Money is based on trust along a broad front. Although a sovereign by putting his stamp on a coin could transform a lump of metal to money and modern monetary authorities can do the same by making a piece of paper legal tender, decree or cohesion is not sufficient in the long run to provide for efficient money. At a fundamental level, efficient money is about preserving the public trust in the issuer of money. In order to safeguard that objective, the freedom of action of monetary authorities must be constrained. Issuing more coins through debasement or clipping might have rendered a sovereign a short-term gain, but at the expense of his personal reputation and public trust in the coins that carried his seal and weakened the usefulness of money. Correspondingly, the breakthrough of bank notes heralded a more efficient form of money, but also carried dangerous temptations for the issuer. With some notable exceptions such as the Bank of England, eighteenth-century note-issuing institutions were prone to temptations.

The lesson learnt, however, was clear: letting the printing press loose to accommodate the financial needs of the sovereign led to depreciation of monetary values and undermined confidence. The second generation of banks of issue, established in the wake of the Napoleonic Wars, became the antithesis of the early experiments. Note-issuing should be rule based and the issuer should always be able to pay out in specie. The case of Norway is presented in detail in Part I.

Moreover, with the coming of the increasingly globalised economy of the nineteenth century, trust was no longer just a question of the domestic public, but involved international financial markets as well. One of the great achievements of the silver and gold standards of that century was the removal of the distinction between domestic and international money. Debasement and over-issuing could no longer take place within a sheltered domestic monetary area, but would have ramification for the international standing and credit of the issuer.[3]

Today the days of specie payments are long gone, but central banks are still as keen as they were 120 years ago in anchoring their monetary creation in a manner that preserves trust in money and the credibility of their issuers. At the root of the question of trust in the monetary authorities is their commitment to sound money. History has shown repeated examples of how governments and central banks have failed to deliver on the promise of safeguarding monetary values. Wars have tended to play havoc with monetary stability, but even in times of peace, the lure to do more or avoid hard choices have easily led astray.[4]

Weakened trust in money comes with a price. Total collapse of money is rare, usually associated with hyperinflation of the German or the Zimbabwean variety. However, even moderate inflation erodes the function as store of value and carries potentially grave negative consequences for our

3 Bordo and Rockoff (1996).
4 Bordo and Kydland (1995) provide historical accounts and explore in particular the potential role of conditional escape clauses in the context of monetary policy rules. Under special circumstances, such as a war or a major crisis, a rule that applies in normal conditions may be temporarily suspended subject to a promise that the rule will be reinstated afterwards.

expectations for the future. If monetary authorities do not put sufficient emphasis on the store-of-value function of money, the public will end up paying undue attention to preserving the purchasing power of their wealth at the expense of wealth creation. A general flight to security seldom enhances overall welfare. Monetary authorities ought to protect monetary values, so that the public can dare more.

Trust as the ability of monetary authorities to deliver sound money is, nonetheless, only a part of the trust issue involving money. With deposits from the middle of the nineteenth century gradually becoming the main component of the money stock, the public would need to put similar faith in the banks with which they entrusted their funds, so that the banks could be trusted as custodians of their deposits. Banking is an inherently risky business; based on a thin film of equity, banks take the money of someone and lend it to someone else (which ought to be seen as scary according to any measure). We actually ask quite a lot of the public; they must trust the character of bankers, their ability to make sound judgments and put faith in the wider financial system of which a bank is a part. This is important. It is a question of trust not just in an individual bank but in the whole web, i.e. the modern monetary system. The need for public trust is not confined to trust only in institutions such as the issuers of high-powered money or banks, but increasingly in the technologies making the system efficient as well. Modern trust in money is also the belief that a credit card payment at the newsagent or an electronic transfer using one's smart phone should be as final as paying with the silver coins of the realm two hundred years ago.

1.5 How Money Is Created: Institutions and Mechanisms

Having established a functional concept of money, we are in the need of an understanding of how money is created. Our endeavours will emphasise two key aspects, the mechanism of monetary creation and the money-creating institutions, both covered in separate sub-sections below. The former is rooted in a theoretical-historical perspective, while the latter can be read as a sketch of the development of banking in Norway over the last two hundred years. A delineation of the present study is its focus on money-creating institutions, notably banks of issue and private deposit-taking banks. Hence, the study does not cover all aspects of credit formation. In the early years credit intermediation mainly consisted of personal credit granted by wealthy individuals through private networks. This information, not covered by the present study, is fragmented and