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— ✤ CHAPTER ONE ✤ —

On Keeping Promises

Why Is Keeping Promises So Difficult?

This house, which now belongs to the Norwegian Academy of Science and Letters, was built by Hans Rasmus Astrup in 1886–1887.[*] Astrup was an entrepreneur. At the age of 20, he left Norway for Barcelona on a ship laden with a cargo of dried cod. He gradually built up a large trading business and later became an industrialist, not unlike businessmen of our own era.[1]

* I would like to thank Ragna Alstadheim for her valuable assistance in preparing this lecture. I would also like to thank Helle Snellingen for her contribution to the translation of the Norwegian text into English.

1 See Reidar Sevåg (1967), *Statsråd H. R. Astrup*, Oslo: Dreyer.

For innovators and the business sector, a stable operating environment has always been important, providing a foundation for adaptation, economic growth, and social progress. A stable value of money is also a component of this foundation.

We were taught as children to keep our promises. If we made a promise, we had to make good on it. But we were also taught that we should not promise too much. If we do not keep our word, others lose confidence in us and our credibility takes a toll. In recent months, we have witnessed that this is of particular importance for the financial system. A proximate example is the situation in our neighboring country Iceland.

The value of confidence and credibility has been the subject of extensive analysis in many fields, including jurisprudence and the social sciences. And the conclusion is clear – progress can be achieved if promises are kept.

If keeping promises is clearly beneficial, why is it then so difficult? The expressions “empty promises” and “empty threats” reflect the temptation to renege. The social scientist and philosopher Jon Elster writes in his book *Ulysses and the Sirens*[2] about weakness of will, shifting preferences over time, and the complexities of

[2] See Jon Elster (1979), *Ulysses and the Sirens: Studies in Rationality and Irrationality*, Cambridge University Press.

human nature. This is familiar ground. As early as 1960, the economist Thomas Schelling[3] discussed similar issues in analyses for which he was awarded the Nobel Prize in economics. According to Schelling, a credible threat can be difficult to establish when realizing the threat involves costs for all the parties involved. A promise or a threat will be more credible if the promisor lets himself be bound to the mast.

Two other economists carried out groundbreaking work when they applied Schelling's analysis to economic issues. In 1977, Finn Kydland from Norway and Edward Prescott[4] from the United States wrote an article showing that authorities who attempt to follow an optimal economic policy plan may have strong incentives to depart from the same plan at a later time.[5] This applies even if no news has emerged to indicate that the plan should be changed. Kydland and Prescott were later awarded the Nobel Prize in Economics for their work.

[3] Thomas C. Schelling (1960), *The Strategy of Conflict*, Cambridge, Mass.: Harvard University Press.

[4] Finn E. Kydland and Edward C. Prescott (1977), "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, Vol. 85, No. 3, pp. 473–491.

[5] In macroeconomics, this dilemma is called the time inconsistency problem.

There is a common denominator between Elster, Schelling, Kydland, and Prescott: keeping a promise is difficult, because reneging on a promise will often be the tempting or rational choice in the short term. If loss of credibility is taken into account, the best solution in the long term will nonetheless often be to keep your word.

A key issue is how we can establish mechanisms that also safeguard long-term objectives in the short term. Jon Elster suggested the metaphor of "binding oneself to the mast." We all know the myth of Ulysses and the sirens, referred to in Elster's work. Ulysses wanted to hear the song of the sirens, but he knew that he and his crew would then come under the sirens' spell, bringing their voyage to an end. He therefore ordered the crew to bind him to the mast, but before they did so, he filled their ears with wax. This prevented him from steering the ship toward the sirens himself, and the crew was prevented from hearing him when he would later succumb to temptation and order the ship to be steered toward the sirens' island. The story cannot be directly transferred to economic management, but the concept of "tying oneself to the mast" is used to describe mechanisms that prevent short-term objectives from taking precedence over long-term objectives. Precluding the possibility of breaking a promise makes the promise more credible. Ensuring accountability for promises made through reporting and review can be a mechanism that binds us to the mast.

A central bank's most important task is to ensure a stable value of money. The value of money relies on responsible economic policies. For a central bank to be able to keep its promise and deliver a stable value of money, it must have the backing of the political authorities. Otherwise, the central bank will not be able to keep its promise.

In the long term, the instruments available to the central bank allow it to deliver only the promise of a stable value of money. Earlier, this promise was kept by regulating the amount of money issued. Today, the instrument is the interest rate. The central bank cannot steer real wages, the labor supply, employment, or the level of unemployment in the long term. But it can contribute to curbing short-term cyclical fluctuations if price stability is firmly anchored.

Throughout history, central banks have attempted to bind themselves to the mast in different ways. In the following, I will discuss the temptations facing issuers of notes and coins, the binding mechanisms that have been tested, and the potential gains for society of a central bank that keeps its promises.

A King's Word Is Worth a Throne – But Sometimes Not a Krone

It has always been tempting for issuers of money to exploit this privilege. It costs less to produce a coin or a banknote than the value printed on it. The added value accruing to the issuer is called seignorage.

Overissuance of notes and coins leads to inflation and a fall in the value of money, and holders of money pay a so-called inflation tax. A sharp fall or strong rise in the value of money also impairs the functioning of the economy because it becomes more difficult to keep track of changes in the price of one good relative to another. It is important that changes in relative prices are easy for both consumers and producers to observe. Otherwise, the function of prices as conveyors of information for consumption, production, and investment decisions will be impaired. The economy will operate less efficiently, resulting in lower growth and welfare.

In the earliest monetary systems, the value of money corresponded to the metal value of the coin. Measured in metal, the value of money was inevitably stable. This system was not as dependent on confidence since the metal content of the coin could in principle be verified at every transaction.

Those in power nevertheless managed to exploit the system. Roman emperors were in the habit of financing their wars by reducing the precious metal content of their coins. This resulted in higher seignorage revenues from each coin issued. For a period, these revenues were sufficient to finance an army, a long war, or several monuments. This is the number one temptation facing money issuers.

Henry VIII of England was one of the most renowned exponents of this kind of behavior[6]. In the 1500s, he reduced the silver content in coins to one third of the original to finance wars against France and his own expensive lifestyle.

In addition to coins, a system gradually developed involving paper money. Banknotes were a receipt for a money issuer's claims on silver or gold. Instead of using coins as a means of payment, the receipt was used. This was more practical, but with the introduction of banknotes the authorities also introduced a new promise. They promised the bearer that they would redeem the nominal value of the notes in silver or gold. The value of the notes was entirely dependent on confidence in the issuer's promise. The authorities' ability to fulfill their

[6] Glyn Davies (2002), *A History of Money from Ancient Times to the Present Day*, University of Wales Press, p. 200.

promises depended on government finances. Brutal tax collectors, a well-filled treasury, and peace with neighboring countries inspired confidence in the authorities' ability to redeem the notes in a precious metal then or at some time in the future.

The authorities often granted a monopoly on banknote issuance to an institution they controlled. This was no coincidence in view of the seignorage revenues generated by printing money. This method of raising seignorage is temptation number two: the authorities borrow money from the issuing bank and the issuing bank provides the loan by printing banknotes. This was particularly common in times of war. It can be difficult to raise taxes or borrow directly from the public to fund an unpopular war. Naturally, a regime at war will be more interested in winning the war than in the long-term economic costs. Who cares about high inflation and debt repayment if surviving as a regime is at stake?

Confidence – and the lack of it – had important consequences for England and France during the Napoleonic Wars. England was able to finance these wars more easily than France. The English government could draw on several funding sources. They raised taxes, but could also borrow, partly from the public and partly from the central bank. They had previously demonstrated that they stood by their commitments, and were therefore granted loans. The French government, on the other hand, had lost its creditworthiness after Louis XVI was sent to the guillotine. The only source of funding that remained was taxation, eliminating the option of spreading war expenditure over time.[7]

Norway's history also illustrates the costs of inflation and a loss of confidence. Soaring inflation in Norway during and after the Napoleonic Wars impaired the functioning of the payment system. The function of money as a unit of measurement was also undermined. An example of this is described in the local history books for the coastal districts of Karlsøy and Helgøy in Troms, northern Norway. At that time, accounts were sometimes kept in silver, or in goods such as cod liver oil, pollock, or flour[8].

Inflation also resulted in the transfer of assets from creditors to debtors: the real value of the fishermen's debt to merchants in Bergen decreased. This marked a historic shift. The fishermen were of course happy to see their

[7] Michael D. Bordo and Eugene N. White (1990), "British and French Finance during the Napoleonic Wars," NBER Working Paper No. 3517, also published in Michael D. Bordo and Forrest Capie (Eds.) (1993), *Monetary Regimes in Transition*, Cambridge University Press.

[8] Håvard Dahl Bratrein (1989–1994), *Karlsøy og Helgøy bygdebok*, Karlsøy kommune, http://karlsoy.com/bygdebok/.

debt diminish. Creditors, however, lost money, which probably did not increase confidence and a willingness to lend the next time someone needed a loan.

The Promise of a Stable Value of Money against Gold and Silver

I have given examples of how easily monarchs succumbed to the temptation of an apparently free lunch by exploiting opportunities for raising seignorage revenues. In times of political instability, they sometimes had no choice. But eventually, the authorities learned that the costs were high. The public pays an inflation tax, the monetary system is impaired, and economic growth slows.

The economic progress experienced by Norway and other countries in the second half of the 1800s was founded on more than a thousand years of money and credit history. The authorities probably knew that a credible promise of a stable value of money measured in metal was one of the cornerstones of the success experienced by towns in northern Italy during the Renaissance and in seventeenth-century Netherlands. They knew that confidence in the promise of a stable value of money could be maintained by relinquishing seignorage and limiting the issuance of money. The opposite was equally