Svein Gjedrem: Monetary policy and wealth management

Address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to the Board of Directors of the National Insurance Fund, Oslo, 14 March 2002.

This address is based on assessments presented at the press conference following the monetary policy meeting of Norges Bank's Executive Board on 27 February 2002, and on previous addresses. Accompanying charts can be found on the Norges Bank's website (www.norges-bank.no).

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The guidelines for economic policy were revised last year. The expected real return on the Government Petroleum Fund is hereafter to be used over the central government budget, and monetary policy is to be oriented towards low and stable inflation.

Economic agents can act on the assumption that low and stable inflation will be a constant feature of economic policy. Wide variations in the price level make it more difficult to predict the real content of agreements and budgets. Unexpected fluctuations in the price level may easily lead to fluctuations in the real economy and instability in financial and property markets. High and variable inflation also leads to an arbitrary redistribution of resources and income. Hence price stability is the best contribution monetary policy can make to economic growth, prosperity and appropriate distribution.

Low inflation is the objective, and the interest rate is the instrument. Commercial and savings banks have accounts with Norges Bank, and the Executive Board decides the interest rate on these. The deposit rate forms the floor for the shortest money market rates.

Transparency about intentions, strategies and the implementation of monetary policy makes it easier for economic agents to assess monetary policy. If monetary policy is predictable, an important source of uncertainty is reduced, and – other things equal – the interest rate required to achieve the inflation target will be lower.

If economic agents are to have confidence in monetary policy, transparency regarding the central bank's response pattern is probably a precondition.

The interest rate affects inflation through a number of channels. An increase in the interest rate will normally contribute to reducing inflation by curbing demand for goods and services and by strengthening the krone exchange rate against other currencies. An interest rate reduction has the opposite effect.

Monetary policy influences the economy with considerable and variable lags. Our analyses indicate that a substantial share of the effects of an interest rate change occurs within two years. Two years is therefore a reasonable time horizon for achieving the inflation target of 2½ per cent. Interest rates are set with a view to achieving an inflation rate of 2½ per cent two years ahead.

Norges Bank's views on the inflation outlook are presented three times a year in the *Inflation Report*. Our projection for inflation in the period ahead is presented as well as our assessment of the balance of risks surrounding this projection. The Executive Board's updated assessments are presented in connection with the monetary policy meetings every six weeks. Immediately after each meeting, the Bank issues a press release and holds a press conference.

The key interest rate is set on the basis of an overall assessment of the inflation outlook two years ahead. Our inflation projections and our views on the balance of risks associated with these projections provide a summary of these assessments.

Norges Bank's inflation projection is our assessment of the most probable outcome of the rise in CPI two years ahead. In setting interest rates we also place emphasis on the probability distribution – or the balance of risks – surrounding the projection. Therefore, we also publish our judgement of the risk associated with our own projections.

The phasing in of petroleum revenues has to be counteracted by a tighter monetary policy than would otherwise be the case. This may be accomplished through an adjustment of the interest rate, an appreciation of the krone or both.

Small countries have experienced fairly wide exchange rate fluctuations. The Swedish krona has depreciated by more than 10 per cent since summer 2000. The Australian dollar has weakened by over 30 per cent since spring 1997. The UK, Canada and New Zealand have also experienced wide exchange rate fluctuations. The Norwegian krone, on the other hand, has been relatively stable.

A monetary policy that is oriented towards low and stable inflation will contribute to stabilising aggregate demand and output. As a result, the central government budget will not normally have to be used actively to stabilise the economy. An increase in unemployment that is due to a higher rate of increase in labour costs than implied by productivity growth cannot be offset by low interest rates or higher public spending and tax cuts, but requires changes in the functioning of the labour market.

The planned use of petroleum revenues implies that the sheltered sector will lay claim to a larger share of the labour force. This will probably cause a decline in manufacturing employment. The ensuing deterioration in competitiveness may lead to restructuring. In the long run, monetary policy cannot influence overall employment or its distribution across industries.

Norway's terms of trade flucture widely. This is largely attributable to variations in the oil price. However, a substantial portion of petroleum revenues is invested in foreign equities and bonds through the Government Petroleum Fund. Changes in the oil price influence the size of the Fund, but have little effect on the domestic use of petroleum revenues. The Petroleum Fund acts as a buffer against fluctuations in the oil price, which stabilises the krone exchange rate.

The Norwegian economy may nevertheless be exposed to disturbances of a type that cannot be absorbed by the Petroleum Fund. We have to be prepared for fluctuations in the value of our currency that are more in line with the fluctuations observed in other countries. The exchange rate will vary. This means that economic agents cannot assume that the krone will be stable against the euro, the US dollar or a weighted average of foreign currencies. It is the inflation target that is the economy's nominal anchor.

The future size of the Petroleum Fund depends on oil price developments. The fiscal guideline ensures that we only use the return on wealth that has already been accumulated. This makes policy robust to changes in oil prices and ensures that petroleum wealth will be of benefit both today and in the future.

The government invests petroleum wealth in foreign securities through the Petroleum Fund. Government wealth is thereby more diversified. These investments have no impact on the Norwegian capital market.

The Norwegian government's most important assets are the Government Petroleum Fund, assets in the National Insurance Fund and government direct ownership interests in enterprises. The Petroleum Fund's equity investments are distributed across many countries, and all equity holdings are less than one per cent of a company's total value.

The National Insurance Fund's investments are mainly confined to Norway. As a result, changes in the value of the Fund's equity portfolio primarily reflect developments in Norwegian business and industry. The Fund has larger ownership interests in individual companies than the Petroleum Fund, and wider fluctuations in value. The government has substantial direct holdings in individual enterprises. In general, concentrated ownership requires a more strategic ownership approach and gives rise to higher risk than diversified ownership.

The capital market serves as an intermediary between the government as investor and enterprises seeking capital. This market makes it possible to separate the government's choices from companies' choices. The distribution of the government's financial investments and the choice of corporate funding structure should not be based on the notion that we are living in a barter economy. The government can choose the composition, required rate of return and risk profile for its financial investments without regard for the funding requirements of Norwegian enterprises. By the same token, Norwegian companies can choose their debt and equity structure independently of the government's financial investments.

Both mainland private saving and business fixed investment have been high in recent years. Thus a possible weak capital market has not been reflected in a low level of investment and saving. As a result of developments in the late 1990s, equities and funds make up an increasing share of households' total assets. The equity ratio of enterprises[1] strengthened in the 1990s, with a rise in new equity capital from the markets in particular.

[1] Norwegian limited companies excluding petroleum companies, financial undertakings and government activities, and groups and holding companies.

The Norwegian loan and capital market probably has weaknesses nevertheless, with thin securities markets and little breadth in investor and owner environments compared with some other countries. The reasons, and hence the solutions, can probably be found in the structure of the taxation of dwellings, property and financial assets, in a high level of government ownership of enterprises and in the organisation of pension saving in Norway. Investing even more government capital in Norway would reduce the return on investments in the Norwegian business sector and prompt other investors to invest elsewhere. Using even more capital in the Norwegian economy would probably also lead to a rapid relocation of jobs to other countries, as the krone would tend to appreciate.