Svein Gjedrem: The conduct of monetary policy

Comments by Mr Svein Gjedrem, Governor of the Central Bank of Norway, on the Norges Bank Watch 2006 report, Oslo, 9 March 2006.

The Charts in pdf-format can be found on the Norges Bank's website.

Please note that the text below may differ slightly from the actual presentation. The speech does not contain references to the next Inflation Report or the monetary policy meeting on 16 March.

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I would like to thank the CME for again providing a thorough review of Norges Bank's conduct of monetary policy in the Norges Bank Watch report. I am also pleased to be invited to comment on the preliminary Norges Bank Watch 2006 report. It is an extensive report that discusses a number of issues.

The report discusses Norges Bank's conduct of monetary policy in 2005 and the previous years, but also focuses on some aspects of our interpretation of the mandate for monetary policy. I will comment first of all on the relationship to the Regulation on Monetary Policy.

As last year, the report emphasises the objective of stabilising the nominal exchange rate. It points to the reference to the exchange rate in the Regulation on Monetary Policy. Last year's recommendation that the Regulation should be printed in its entirety in each Inflation Report is reiterated.

Norges Bank's mandate provides a basis for the conduct of monetary policy:

"Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time. [...]"

The responsibility for implementing monetary policy is delegated to Norges Bank pursuant to the Norges Bank Act and the appurtenant Regulation. The Bank sets interest rates based on our interpretation of the Regulation. In our interpretation, we give weight to the Government's rationale for the Regulation, to the purpose as expressed in the first section, and to our knowledge about the relationships between the interest rate, the exchange rate, output, employment and inflation.

The first sentence in the mandate refers to the value of the krone. Stability in the krone's internal value implies that inflation must be low and stable. Low and stable inflation contributes to economic growth and to stability in financial and property markets.

The Regulation also states that monetary policy shall be aimed at stability in the Norwegian krone's external value, contributing to stable expectations concerning exchange rate developments. Norges Bank has not set a specific target for the level of the krone exchange rate. With open trade with other countries and free capital movements, we do not have the instruments to fine-tune the krone exchange rate. The task of monetary policy is to provide a nominal anchor. The inflation target is such an anchor. Stable inflation expectations can contribute to more stable expectations concerning the krone, but the rise in public expenditure and in prices for internationally traded goods also affect economic agents' expectations as to the krone exchange rate.

Our interpretation of the mandate is included in the Inflation Report. An account is also given of how different developments, including movements in the exchange rate, will affect the monetary policy outlook.

Over time, the real exchange rate will be determined by conditions other than monetary policy. The real exchange rate may be measured in a number of ways: for example, by relative consumer prices and relative labour costs between Norway and its trading partners, measured in a common currency. The real exchange rate has fluctuated considerably and has at times deviated substantially from the average level since 1970. Nevertheless, there has been a tendency for the real exchange rate to revert to this level.

The cost level in the Norwegian economy compared with our trading partners rose sharply when the oil age began. Since then, the level has fluctuated to a certain extent without showing a clear upward or downward tendency. Over time, the level has been adjusted to the use of petroleum revenues. When we subsequently arrive at the point where the portion of our import requirements that can be financed by petroleum revenues starts to diminish, Norwegian competitiveness will have to be improved. Prize-winning research conducted by Farooq Akram ("Oil Wealth and Real Exchange Rates; the FEER for Norway", Norges Bank Working Paper 2004/16) shows that the real exchange rate may have to revert to the levels prevailing at the end of the 1960s, before Norway became an oil nation. Such a depreciation can be achieved either through price and wage inflation that is lower in Norway than in other countries or through a depreciation in the nominal exchange rate. The latter would be the least painful method, and with a flexible exchange rate, it is also the most probable.

Norges Bank Watch also raises the issue of how monetary policy should safeguard the objective of financial stability. The report emphasises that economic literature does not provide unequivocal recommendations as to whether or how this should be done. The report nevertheless expresses concern with regard to the rise in house prices and credit growth. The report notes that asset prices, and particularly house prices, can influence household and business saving and investment decisions, and thereby affect real economic developments. Monetary policy can also influence developments in inflation, output and employment through its impact on asset prices. This description corresponds closely with our own understanding of how the economy functions.

Household debt has increased sharply since the mid-1990s. At the same time, house prices have shown a marked increase. Debt developments in the 1990s can probably be viewed to some extent as a delayed adaptation to the deregulation of the housing and credit markets in the 1980s, after many households burned their fingers immediately after deregulation. In recent years, household income growth has been solid, household confidence regarding the future has been strong and households probably perceive higher income levels as permanent. This may have resulted in a further rise in house prices and debt. In addition, low real interest rates are now making a contribution.

In countries that have had liberalised credit markets for a long time, Denmark for example, where credit markets were liberalised over a hundred years ago, the household debt-to-income ratio is higher than in other countries. Norwegian households have a high level of debt, but there are examples of countries where household debt is even higher when we compare Norway with some of our trading partners.

Developments in growth in credit to households in Norway nevertheless give cause for concern. We have examples showing that the subsequent effects of a period of unusually high house prices can persist for a very long time. At the end of the 1800s, house prices rose sharply in Christiania (now Oslo). The effects of the very high level of housing construction that resulted from the rise in prices are still perceptible in parts of Oslo. At that time, the housing market collapsed. The market for new dwellings was saturated. Real house prices did not revert to the 1899 level until the mid-1980s.

The rise in house prices has been high in Norway in recent years, but not particularly high compared with other countries. We have limited scope for restraining structural changes that occur when households increase their debt over several years to invest in housing and other property and assets. An interest rate that would effectively restrain these structural adjustments would also have an adverse impact on economic activity. But households are more vulnerable when debt levels are high. Long periods of a sharp rise in asset prices and debt may give rise to instability in output and employment at a later stage. Debt developments also affect banks' behaviour. A particular responsibility for monitoring developments in financial institutions has been assigned to Kredittilsynet (Financial Supervisory Authority of Norway), and we are happy to have a well-equipped supervisory authority in this field.

In its forecasting of economic variables, Norges Bank uses a broad approach. Current statistics and impressions from Norges Bank regional network are important in assessing the current economic situation. In its forecasting, the Bank uses several macroeconomic models: one core model and a number of smaller models. There is, however, no mechanical relationship between the models the Bank uses and its forecasts. The Bank's forecasts are based on a broad and varied range of information sources and include a substantial element of judgment.

Important components in the assessment of what constitutes a good interest rate path – and which stress the element of judgment in this assessment – are expressed in a set of criteria that should be met. The criteria are included in the Inflation Report. Criteria have been set for robustness and financial stability. It is also appropriate to assess interest-rate setting against cross-checks such as simple monetary policy rules.

The central balance is nevertheless between the inflation outlook and the outlook for capacity utilisation in the economy, expressed in the chart as the output gap. The projections are from Inflation Report 3/05. If monetary policy is to anchor inflation at the target, the interest rate must be set so that inflation moves towards the target. Inflation should be stabilised close to the target within a reasonable time horizon, normally 1-3 years. Provided inflation expectations are on target, the inflation gap and the output gap should be in reasonable proportion to each other until they close. Looking ahead, the inflation gap and the output gap should normally not be positive or negative at the same time.

Several of the recommendations from Norges Bank Watch can be translated into how we should weigh the outlook for these two variables against each other.

According to the report, Norges Bank's inflation projections through 2005 were fairly accurate. Inflation has risen somewhat but is still very low, even 2½ years after the cyclical change. Inflation is still being restrained by the fall in prices for imported consumer goods, increased competition in a number of markets and the current period of lower nominal pay increases. The trend in prices for consumer goods over the past two or three years is a result of favourable developments in the Norwegian and global economies. Low inflation is being accompanied by real income growth and a rise in production. It cannot be ruled out that small open economies are particularly vulnerable to fluctuations in international prices. Deviations from the inflation target in Norway are broadly in line with Sweden and New Zealand, but are larger than for example in the UK and Canada.

Developments in recent years have also been influenced by the fairly large favourable disturbances to which the Norwegian economy has been exposed. Developments in Norway's terms of trade provide an illustration of this here.

As consumers, we enjoy the benefits of falling prices for many imported goods. As a nation, we benefit from a fall in prices for the goods we import in relation to prices for the goods we export. Norway's terms of trade are improving. The impact of the rise in oil and gas prices is particularly strong – and the domestic economy is shielded to a certain extent through the oil fund mechanism – but there have also been terms-of-trade gains in the mainland economy. The situation in Norway differs from that of our Nordic neighbours.

It should also be noted that the figures for the twelve-month rise in consumer prices are considerably more volatile in Norway than in other countries. We see from the figures that consumer prices in Norway, even when tax changes and energy products are excluded, are more volatile than indices in other countries where these products are included.

Low inflation is not the result of declining demand, activity or employment. In our conduct of monetary policy, we weigh the objective of stabilising inflation close to 2½ per cent over time against the objective of stable growth in output and employment. Since inflation is low, we have chosen to keep the interest rate at a low level and have at times considered an even lower interest rate. However, as the Norwegian economy has shown solid growth since summer 2003, we decided instead to use some time to bring inflation back to target. In a period of increasing cross-border labour flows, substantial technological advances, changes in competitive conditions and new trading patterns, we may, with our very open economy, have to accept a somewhat greater variation in inflation and deviations from the target, as we have witnessed over the past two to three years.