Svein Gjedrem: Ten years of inflation targeting strategy in Poland compared with the experience of other countries

Presentation by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference "20 years after the collapse of the socialist economy. Transformation, economic growth and convergence in Poland and other Central and Eastern European countries ", National Bank of Poland, Warsaw, 5 June 2009.

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Thank you for the invitation to speak at your conference. It is a pleasure for me to be here in Warsaw on this occasion.

Norges Bank was given an inflation targeting mandate in 2001. Inflation expectations have been well anchored around the 2.5 per cent target rate in recent years.

We practice flexible inflation targeting. The credibility of our inflation target has enabled monetary policy to support a stable economic growth path. However, like other countries, Norway was hit by the international economic downturn that followed the financial crisis. The estimated growth rate for 2009 is minus one percent.

Preceding the downturn, we went through a long period of low CPI inflation. Headline CPI in Norway is strongly affected by fluctuating energy prices. An inflation measure that instead includes trend energy prices, CPIXE, illustrates how the inflation rate gradually has been approaching our target of 2.5 per cent.

In this – until the fall of 2008 – rather benign macroeconomic environment, rising property prices, high credit growth and a low saving ratio posed a policy challenge – as in many countries. A high leverage ratio makes the financial system, and in effect the whole economy, more sensitive to fluctuating asset prices.

The present downturn in Norway was not triggered by moving asset prices, but rather by the international downturn. Still, the effect of the international downturn on our economy is probably stronger than it would have been with a better regulatory framework.

A consensus is emerging internationally that new tools are needed in order to make the financial system more robust with respect to macroeconomic fluctuations. Moreover, the financial system should help dampen rather than amplify or even cause fluctuations. The new tools – macro-prudential policies – are needed regardless of the monetary policy regime in place in any given country. For Norway, as a small EU outsider, it is hard to see any better option than inflation targeting. Indeed, it has been a strength in the current downturn to have a credible inflation targeting regime in place.

We have tried to have a long-term perspective on attaining the target. This was especially important when the economy was hit by a supply shock, and we needed to trade off reaching the inflation target and closing the output gap. Inflation was below target until last year. Now, hit by a demand shock and looking ahead, we know that a trade-off is absent – the economy needs stimulus. But in the face of an unusually high degree of uncertainty, and given an unusually large shock, I believe that it is sensible to continue to be patient. We still try to have a long-term perspective, and we will carefully consider the effects of measures already taken as we move along.

Even with monetary policy able to counteract cyclical fluctuations to some extent, there is a limit to how much the one tool at the central bank's disposal – the key policy rate – can accomplish. Regulations need to underpin the robustness of the financial system with respect to cyclical fluctuations. Supply side policy needs to support the capacity of the economy to absorb asset price fluctuations.

As for regulatory reform of the financial sector, I believe we both need to reconsider the structural elements and we need some new discretionary features. In order to limit excessive credit growth, the leverage ratio of banks should be contained, with higher capital requirements.

The procyclical effects of such capital requirements need to be addressed. Since profits fall during a recession, capital requirements then tend to be more binding, reducing credit availability when it is most needed. The work aimed at changing the procyclical effects of capital requirements is still in its infancy. Banks' incentives to increase loan provisions during upturns could be strengthened. This would smooth profits and hence make capital requirements less procyclical. Ideally, loan provisions should internalise some of the cyclical risk by being based on longer term risk assessments.

In addition, one could reduce the procyclical effects of capital requirements more directly by making the capital requirements themselves more flexible over the cycle. Imposing capital requirements always involves a trade-off between financial stability concerns and efficient capital allocation. In a downturn, when concern about the availability of credit may be greater than in an upturn, a temporarily reduced capital requirement may be justified. The condition must be that the buffer is built up again during the upturn. Such time variant capital requirements would also be demanding to implement, however. It would leave the relevant authority with the discretion to assess the cyclical situation and impose appropriate capital requirements. The time horizon over which the economic outlook should be assessed would have to be several years, in order to cover the full cycle.

As for ways to make the economy – in Norway and in a number of other countries – more robust to asset price fluctuations, I think household incentives to borrow and invest in residential property should be reduced. Tax deduction of interest against income, combined with too low or non-existing property taxes, contribute to a high leverage ratio.

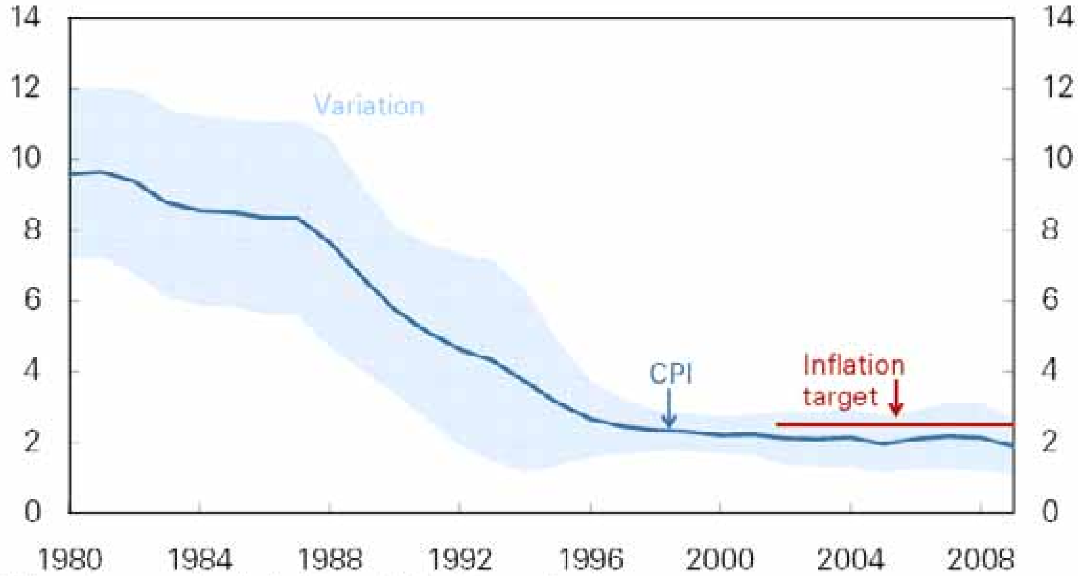
Earlier, I spelled out some challenges involved in implementing macro-prudential policy measures. I did not mention the important international aspects of these issues. First, given banks' cross-border activities, it is of particular importance to establish a level playing field and avoid competition among regulatory authorities. Lax regulation in one area would undermine everybody's efforts to reduce systemic risk.

Second, in order for the economy to benefit from attempts to make the effect of regulations less pro-cyclical, discretionary elements of the system would have to be coordinated across borders.

I believe the Nordic countries could be a good testing ground for macro-prudential policies. Nordic owned banks cover most of the market in the Nordic area, including the Baltic states. One hurdle that one would have to overcome would be different cyclical developments across Nordic countries. Capital requirements would need to be linked to customer location. For example, credit to Norwegian firms would have to be subject to a higher capital requirement than credit to Finnish firms, if Norway were in a boom and Finland in a recession. I hope that this challenge can be solved and that the next recession will be met with a better macro-prudential framework in place.

Inflation. Moving 10-year average[1)] and variation[2)] in CPI[3)].

Per cent. 1980 – 2009



1) The moving average is calculated 7 years back and 2 years ahead.
2) The band around the CPI is the variation in the CPI adjusted for tax changes and excluding energy products in the average period, measured by +/- one standard deviation.
3) Projections for 2009 – 2011 form the basis for this estimate.
Sources: Statistics Norway and Norges Bank

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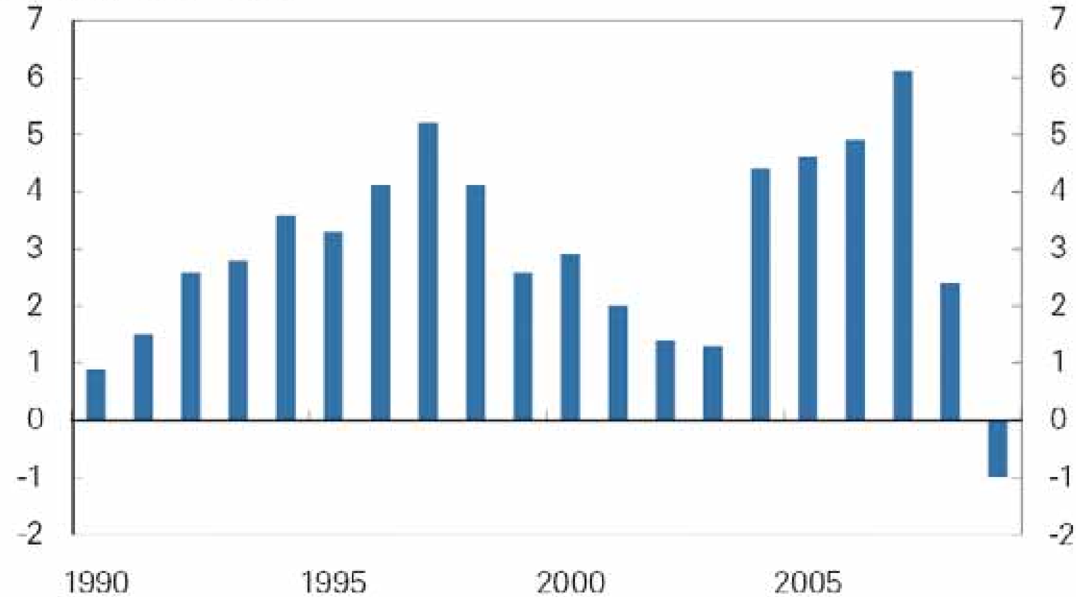
Mainland GDP. Annual volume change

Per cent. 1990 – 2009[1)]



1) Projections for 2009
Sources: Statistics Norway and Norges Bank

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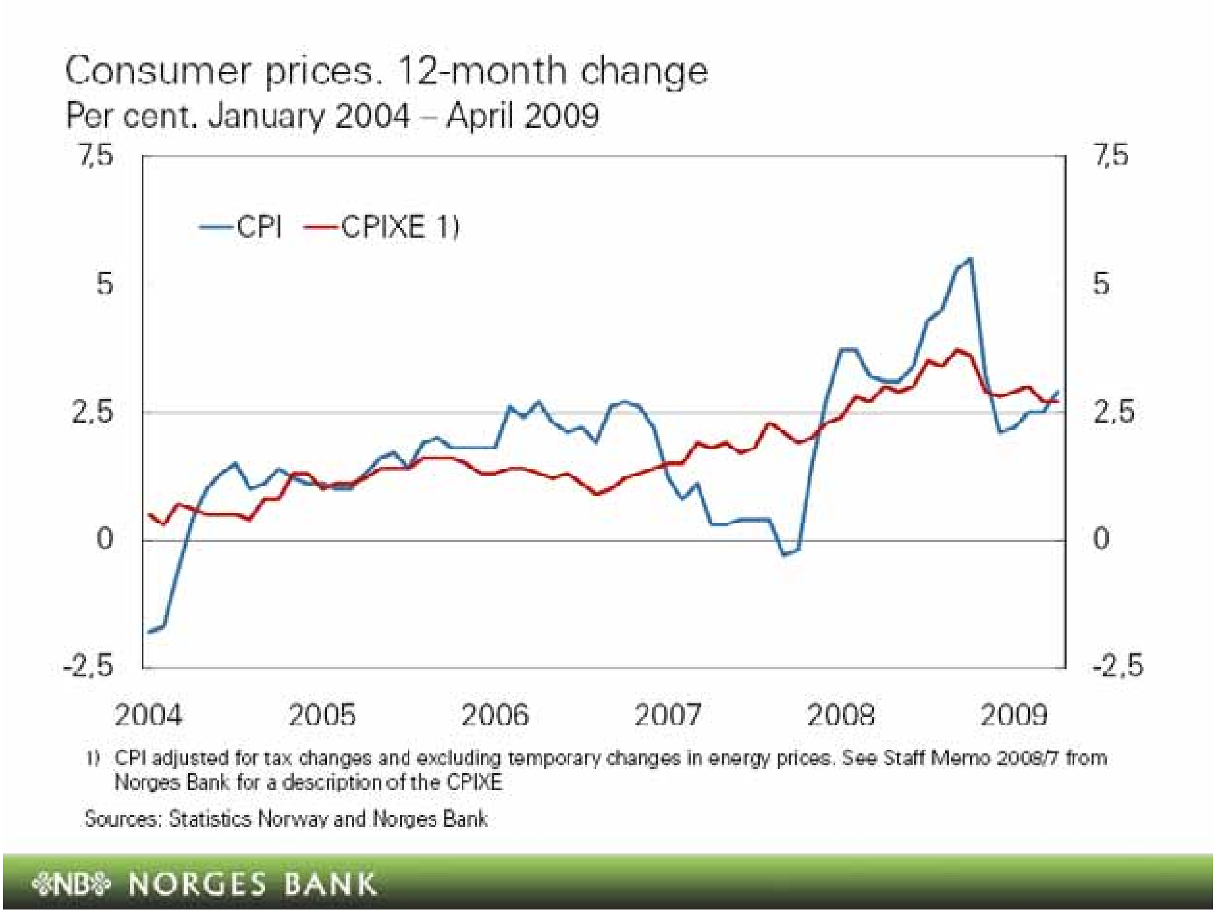
Consumer prices. 12-month change
Per cent. January 2004 – April 2009
CPI
CPIXE 1)
7,5
5
2,5
0
-2,5
2004
2005
2006
2007
2008
2009
1) CPI adjusted for tax changes and excluding temporary changes in energy prices. See Staff Memo 2008/7 from Norges Bank for a description of the CPIXE
Sources: Statistics Norway and Norges Bank
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